



September 29, 2017

The Honourable Bill Morneau  
Minister of Finance  
Finance Canada  
90 Elgin Street  
Ottawa, ON  
K1A 0G5

Dear Minister Morneau:

**Re: CALU Submission on the Department of Finance Consultation Paper Released July 18, 2017  
Relating to Section 84.1 and Family Business Succession**

We are writing on behalf of the Conference for Advanced Life Underwriting (CALU). CALU is a national professional membership association of established financial advisors (life insurance, wealth management and employee benefits), accounting, legal, tax and actuarial professionals. For over 25 years CALU has engaged in advocacy and government relations activities on behalf of its members, and its sister organization, Advocis. Through these efforts, CALU represents the interests of more than 12,000 insurance and financial advisors and in turn the interests of millions of Canadians, including shareholders of private corporations.

Further to the Department of Finance ("Finance") consultation paper released on July 18, 2017 (the "consultation paper"), we wish to provide our comments on how it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuses of any such accommodation.

**Background**

It is no secret that small businesses play a significant role in the Canadian economy. In 2015 small businesses employed more than 8.2 million Canadians, representing over 70% of the total private labour force.<sup>1</sup> In turn, small businesses account for approximately 30% of Canada's total Gross Domestic Product (GDP).<sup>2</sup> It is critical that provincial and federal government policies not only encourage the ongoing growth of small businesses, but also support the successful transfer of those businesses to the next generation of owners through tax rules that establish a level playing field for all.

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<sup>1</sup> Industry Canada, Key Small Business Statistics June 2016.

<sup>2</sup> Ibid, for the 2014 calendar year.

The boomer generation of small business owners are now entering their retirement years. Many of these business owners are planning to sell or otherwise exit their businesses in the next five to ten years, and a significant percentage want to pass on their businesses to family members.<sup>3</sup> This is indeed a critical time for owners of small businesses, who need to realize the value of their lifelong efforts while ensuring the business remains successful once it has transitioned to new owners. The best decision is often to have their business remain within the family.

To foster this transition of Canadian small businesses, the Canadian tax rules applicable on the disposition of the business should not create biases that favour selling the business to non-family members. This would allow a business owner to ensure that the business can be transferred to a new owner that is best able to operate the business for future success. A successful inter-generational transition executed in a tax efficient way will assist these businesses in continuing to make their significant contribution to the Canadian economy.

Unfortunately, existing tax rules can actually penalize the owners of incorporated businesses who sell shares to a corporation controlled by other family members, thus creating a bias toward a sale to arm's-length purchasers. These tax rules generally convert the capital gain that would otherwise arise on this transaction into a deemed dividend.<sup>4</sup> This both prevents the business owner from claiming the lifetime capital gains exemption (which in 2017 will exempt almost \$840,000 in capital gains from taxation), but also subjects the gain to higher dividend tax rates. A similar transaction involving an arm's-length purchaser would not result in the application of these rules, which effectively creates an uneven playing field for both the purchaser and seller.

Current tax rules will also have a negative impact on purchasers who buy the shares directly from a family member. Specifically, where there is a sale between family members and the seller claims the lifetime capital gains exemption on the shares, the purchaser is considered not to have adjusted cost base on the shares acquired ("hard basis") to the extent of the exemption claimed (the denial being typically referred to as "soft basis"). While a purchaser's hard basis can generally be extracted from the company on a tax-free basis (i.e., the purchaser can withdraw from the company tax-free the tax-paid money paid for the shares), the soft basis cannot. A third-party purchaser would not be subjected to the rules relating to soft basis.<sup>5</sup>

As a result, business owners may feel they have no other choice but to sell the business to non-family members in order to preserve the more advantageous capital gains tax treatment. Alternatively, the business owner is forced to structure the sale to a family member in a way that significantly increases the after-tax costs of financing the sale, straining their financial resources and those of the business.

We believe such result not only negatively impacts the family, but potentially the community where that business is relocated, in those situations where the acquirer consolidates the combined business operations.

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<sup>3</sup> "Passing on the Business to the Next Generation", November 2012. This report is based on responses from approximately 8,300 CFIB members to a survey conducted from March 9 to May 4, 2011.

<sup>4</sup> Section 84.1 of the Income Tax Act (Canada) (the "Act").

<sup>5</sup> Note that Finance proposals released on July 18, 2017 would broaden the application of section 84.1 so that soft basis arises on any previous capital gain realized by a non-arm's length person; not just capital gains on which the lifetime capital gains exemption was claimed; and not just on transfers of shares to a non-arm's length person.



### Section 84.1 – Purpose and Scope

Section 84.1 is an anti-avoidance provision intended to prevent the stripping of surplus from a corporation on a tax-free basis by using the lifetime capital gains exemption and/or value accumulated in a corporation before 1971 (“V-day value”) in a non-arm’s-length situation. A reduction in the paid-up capital of the shares received on the transaction (or substituted shares) and/or a deemed dividend can result depending on the transactions involved.

The deemed dividend rules in section 84.1 will apply in the following circumstances:

1. An individual (not a corporation) (the “taxpayer”) who is resident in Canada disposes of shares (the “subject shares”);
2. The subject shares are shares of a corporation (the “subject corporation”) resident in Canada;
3. The subject shares are capital property;
4. The disposition is to another corporation (the “purchaser corporation”) with whom the individual does not deal at arm’s length; and
5. Immediately after the disposition, the subject corporation and the purchaser corporation are connected.

The rules in section 84.1 that do not allow hard basis will apply when shares are acquired by an individual who does not deal at arm’s length with the taxpayer and the taxpayer claims the lifetime capital gains exemption on the shares.<sup>6</sup>

The term “arm’s length” is dealt with in subsection 251(1) of the Act. “Related persons” are deemed to not deal with each other at arm’s length and it is a question of fact whether persons not related to each other deal at arm’s length.

A related person is defined in subsection 251(2) and includes those individuals connected by blood relationship, marriage or common-law partnership or adoption. The subsection also defines when individuals are related to corporations. In general, an individual will be related to a corporation where:

- (i) The individual controls the corporation,
- (ii) The individual is a member of a related group that controls the corporation, and
- (iii) The individual is related to the person in (i) or (ii) (for example, the spouse of the person who owns the shares in the corporation).

For purposes of the deemed dividend rules in section 84.1, corporations are “connected” if one corporation controls the other or if one corporation owns shares having more than 10% of the votes and value of the other corporation.<sup>7</sup>

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<sup>6</sup> Ibid.

<sup>7</sup> Subsection 186(4) of the Act. Subsection 186(2) of the Act provides that one corporation will be deemed to control the other corporation if the first corporation, and any person who deal’s non-arm’s length with that corporation, own share capital of the second corporation that, in total, provide more than 50% of the voting rights in the second corporation.



If the conditions of the deemed dividend rules in section 84.1 apply, there are two possible consequences:

- (i) If the transaction involves the receipt by the taxpayer of shares of the purchaser corporation as consideration for subject shares, there may be a reduction in the paid-up capital of the purchaser corporation's shares; and/or
- (ii) Generally, to the extent of other consideration received by the taxpayer for the subject shares, the purchaser corporation may be deemed to have paid a dividend to the taxpayer.

Either or both of these consequences may arise when the non-share consideration (i.e. cash or debt) received or the paid-up capital of the purchaser corporation's shares is more than the greater of the hard basis and the paid-up capital of the subject shares.<sup>8</sup> To determine the "arm's-length" adjusted cost base ("ACB"), certain adjustments are made to ensure that the shareholder cannot extract corporate surplus on a tax-free basis. For example, if the shares were acquired from a non-arm's-length person who used their lifetime capital gains exemption, there is a reduction in the hard basis of those shares.<sup>9</sup>

### Impact of Section 84.1 on Small Business Owners - Current Rules

The following example illustrates the adverse impact that the currently enacted version of section 84.1 can have on the transfer of shares in a private business.

Assume Mr. Smith owns 100% of the common shares of XYZ Co., and those shares qualify for the lifetime capital gains exemption.<sup>10</sup> Jane, his daughter, has been working in the business for a number of years and is interested in acquiring his shares when he retires. The shares are independently valued at \$1.2 million, with a nominal ACB and paid-up capital. Mr. Smith and Jane are subject to a 39% tax rate on dividends from XYZ Co. and a 24% tax rate on capital gains.<sup>11</sup> Mr. Smith is entitled to claim a lifetime capital gains exemption in respect of \$800,000 of capital gains on the disposition of the shares.

#### (i) Sale of Shares to Arm's-Length Corporation

Mr. Smith is approached by an arm's-length corporation ("ArmCo"), which is interested in purchasing all his shares. Mr. Smith agrees to sell his shares to ArmCo for \$1.2 million. As a result of the sale, Mr. Smith will have a capital gain of \$400,000 after utilizing the lifetime capital gains exemption.<sup>12</sup> The resulting tax liability will be \$96,000, leaving him with after-tax proceeds for his retirement of just over \$1,100,000.

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<sup>8</sup> The formulas for calculating the paid-up capital reduction and deemed dividend are in paragraphs 84.1(1)(a) and (b) respectively.

<sup>9</sup> Supra note 5.

<sup>10</sup> Section 110.6 of the Act. The current capital gains exemption for qualifying small business corporation shares is approximately \$835,716.

<sup>11</sup> Based on tax rates similar to the 2017 Ontario tax rates for an individual taxpayer earning between \$150,000 and \$200,000.

<sup>12</sup> If the receipt of sale proceeds is to be spread over a number of years, Mr. Smith could also claim a capital gains reserve over up to five years under paragraph 40(1)(a) of the Act.



Armco could borrow the \$1.2 million purchase price and fund the repayment of this loan by paying tax-free inter-corporate dividends<sup>13</sup> from XYZ Co.'s profits over the following years.<sup>14</sup> The total cash flow cost to XYZ Co. would be \$1.2 million plus the after-tax interest expense.

(ii) Sale of Shares to Jane

Rather than selling the shares in XYZ Co. to an arm's-length corporation, Mr. Smith agrees to sell the shares to a corporation controlled by Jane for \$1.2 million in cash. Because Mr. Smith deals on a non-arm's-length basis with Jane's corporation, section 84.1 will apply and Mr. Smith will be deemed to have received a dividend of \$1.2 million. Mr. Smith will therefore not be entitled to claim the lifetime capital gains exemption and will have a resulting tax liability of \$468,000 which is almost five times more than the tax payable on the sale of shares to ArmCo. Mr. Smith's after-tax proceeds shrink by over 33% from \$1,100,000 to \$732,000.

To avoid the application of section 84.1, Jane could directly purchase the shares from her father. In this case Mr. Smith's tax bill would be equal to what would arise on the sale of the shares to ArmCo.<sup>15</sup>

However, if Jane needs to borrow the \$1.2 million to pay for the shares in XYZ Co., because she does not have hard basis for \$800,000 of the purchase price for the shares, after the purchase, XYZ Co. would need to distribute over \$1.9 million in non-eligible dividends to Jane to enable her to net \$1.2 million after-tax to repay the loan.<sup>16</sup> This represents almost a 60% increase over the amount that XYZ Co. would be required to distribute where an arm's-length purchaser finances the purchase of shares.

### The Growing Punitive Impact of Section 84.1

Although section 84.1 has been in place for over 30 years, the tax implications of its application have grown dramatically more punitive since it was first introduced.

Consider the following:

In 1986 the top individual tax rate<sup>17</sup> on capital gains was 28%, the top individual tax rate on dividends was 18%, and the capital gains exemption was limited to \$500,000. Using the same fact pattern as above, the tax payable by Mr. Smith on an arm's-length sale would be \$196,000. However, if the full capital gain was treated as a taxable dividend due to the application of section 84.1, the amount of tax would be \$216,000. In this example, while there still was a tax penalty arising from the application of section 84.1, it was marginal because of the lower capital gains exemption and dividend tax rates at that time.

In 2001 the top individual tax rate on capital gains and dividends was the same at 34%, with the capital gains exemption remaining at \$500,000. Using the same fact pattern as above, the tax payable by Mr. Smith on an arm's-length sale would be \$238,000. However, if the full gain was treated as a taxable dividend, the amount of tax would be \$408,000. While there was a higher tax penalty associated with

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<sup>13</sup> Subsection 112(1) of the Act.

<sup>14</sup> Subsection 55(2) would not apply to the intercorporate dividend.

<sup>15</sup> Note, however, Jane would not have hard basis for \$800,000 due to her father claiming the lifetime capital gains exemption.

<sup>16</sup> This ignores the interest charges incurred by Jane on the loan.

<sup>17</sup> Based on British Columbia provincial tax rates and federal tax rates.



the application of section 84.1 (in comparison to 1986), it is still significantly lower in both percentage and absolute amounts than what would arise from the application of those rules today.

In summary, a combination of increasingly onerous tax implications arising from the application of section 84.1, as well as a lack of financing options for new business owners, justify a review of the application of section 84.1 to ensure it continues to meet the appropriate policy goals.

### **Discussion - Hallmarks of a Genuine Business Transfer**

In the consultation paper, it is suggested that the hallmarks to ensure a genuine transfer of a business to a new owner would generally include:

- the vendor ceasing on the transfer to have factual and legal control of the transferred business;
- the intent of the new owner to continue the business as a going concern long after its purchase;
- the vendor not having any financial interest in the transferred business; and
- the vendor not participating in the management and operations of the business.

The consultation paper also notes:

For example, the United States has long-standing rules meant to distinguish cases where a parent “terminates” his or her interest in a corporation on the sale of shares to a family member including a corporation controlled by family members. In general terms, the approach of the United States is to rely on rules that establish a bright-line test that is not amenable to factual disputes about the genuineness of an intergenerational transfer of the small business corporation. It does so by simulating a straightforward arm’s-length sale in which the vendor has no interest or involvement in the transferred corporation after the sale.

The American approach arguably accommodates genuine intergenerational transfers because it does not prevent a parent/owner of a private corporation from having the corporation employ their children in the years leading up to the actual transfer. During this period, the parent can transfer knowledge of the business to the child as well as assist the child in gaining the experience necessary to operate the business as a future owner.

We also note that the Province of Quebec has introduced an exception to the Quebec Taxation Act rules that are the equivalent to section 84.1.<sup>18</sup> Generally, these measures apply where the following conditions are met:

1. The exception applies to shares that are qualified small business corporation<sup>19</sup> shares of private corporations.
2. The taxpayer disposing of the shares must be an individual other than a trust.
3. The taxpayer disposing of the shares (or the taxpayer’s spouse) must have played an active role and held a substantial interest in the business (effectively 25% of votes and value) during the 24 months preceding the disposition.
4. The taxpayer disposing of the shares (or the taxpayer’s spouse) does not play an active role in the business after the transaction.

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<sup>18</sup> Sections 517.1 to 517.3 of the Quebec Taxation Act, C I-3. These measures apply to dispositions taking place after March 18, 2016.

<sup>19</sup> As defined in subsection 110.6(1) of the Act.



5. The taxpayer disposing of the shares (or the taxpayer's spouse) does not exercise du jure control after the transfer of the shares.
6. The taxpayer disposing of the shares (or the taxpayer's spouse) does not hold common shares of the corporation after the transaction.
7. The total fair market value of all the residual financial interests held by the transferor in the transferred business must not be greater than 60% (80% in the case of a farming or fishing business)<sup>20</sup>; and
8. After the sale, at least one person participating as a shareholder in the acquiring corporation plays an active role in carrying on the business.

While appreciating the benefits of the United States' "bright line" test requiring that the departing business owner terminate all interests in the business after the transfer of shares, this is not typically what happens, on the sale of a small business, and we would strongly suggest is not a feasible precondition. Small business owners are traditionally not adept at planning the transition of their business to a new owner, and the timing of the transition may be forced upon them due to health concerns.<sup>21</sup> As well, not being able to structure a buy-out where the departing owner retains an equity stake, or provides long-term financing, can put a significant financial strain on the new owners. In fact, as discussed below, ongoing participation of the departing owner (both working in the business and continuing an ownership interest) in the small business is a relatively common condition in arm's-length transactions.

We have attached for your reference a letter prepared by an expert in the area of arm's-length acquisitions and divestitures of Canadian private corporations.<sup>22</sup> The relevant portions of his letter are reproduced below:

#### **Continued Financial Interest**

It is not unusual for the vendor of a privately-held Canadian company to retain a financial interest in the transferred business. Notable circumstances where this occurs include:

- the sale to a private equity firm. Such purchasers normally prefer that the vendor retain an equity position in the transferred business to align the interests of the parties. In some cases, the vendor may retain a majority equity position, although their ability to unilaterally control the business is subject to the provisions of a shareholder agreement;
- corporate buyers or individual investors who prefer to acquire a majority equity stake in the business. Such a transaction structure reduces the initial cash outlay for the purchaser and creates an economic incentive for the vendor through the put-call provisions of the retained equity interest; and
- a sale of the business to arm's-length management, who may have limited financial resources and must acquire the shares over time.

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<sup>20</sup> There are a number of other terms and conditions applicable to financial interests retained by the transferor of shares.

<sup>21</sup> Many small business owners simply work until they are no longer able to do so.

<sup>22</sup> Appendix A - Letter dated September 12, 2017 by Howard Johnson, MBA, FCPA, FCA, FCMA, FCBV, CPA, CFA, ASA, CF, C.Dir.



In lieu of, or in addition to, retaining an equity interest, many arm's-length transactions involve the vendor retaining a debt obligation against the transferred business. The obligation to the vendor is normally structured as a promissory note (or retractable preferred shares) which is subordinated to other obligations in the business. Such transaction structures (commonly referred to as a "vendor take-back") are frequently used in the acquisition of small and medium-sized private companies where the purchaser (often another small private company or individual) cannot secure sufficient financial resources at the closing date. The promissory note (or series of notes) may extend for several years following the transaction.

### **Continued Management Participation**

It is very common for the vendor to continue participation in the management and operations of the transferred business. In fact, it is unusual for the vendor of a privately-held company to make a "clean break" at the closing date of the transaction. As a condition to the transaction, purchasers normally insist that the vendor enter into a management or consulting agreement to help facilitate the transition, particularly with respect to proprietary know-how, employee morale and customer relationships.

The duration and responsibilities of the vendor under the management or consulting agreement depends on numerous factors, including the nature of the business itself, the vendor's involvement in the business prior to the transaction, the experience and capabilities of the management team, and the vendor's health and personal circumstances. Where the transaction is structured such that a portion of the purchase price is contingent on the future operating results of the business (i.e. an earnout), the vendor normally insists on their continued involvement in the business and their ability to manage the business in a way that maximizes the likelihood of achieving the earnout metrics.

Based on the foregoing discussion, and considering the dynamics and needs of family owned businesses, we believe any exception to section 84.1 should permit the limited but ongoing participation of the transferor in the business (both from an ownership and management perspective) for a reasonable period of time. Our recommendations outlined below support this approach.

### **Suggested Amendments to Section 84.1<sup>23</sup>**

CALU supports a limited exception to section 84.1, which will apply where a controlling interest in a small business corporation is sold directly or indirectly to adult children or grandchildren of the transferor.

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<sup>23</sup> If the Department of Finance proceeds with proposals set out in the Consultation Paper released on July 18, 2017, this exception will need to be expanded to possibly include other sections of the Income Tax Act including revised subsection 120.4(4) and proposed section 246.1 of the Act.



This section outlines key questions relating to the scope of the exception and CALU's recommended approach.

*a) Should the Vendor be a certain age to qualify for the exception?*

We believe it would be appropriate to establish a minimum age (for example, age 50) before the transferor is entitled to claim the exception from section 84.1. As well, the exception should be available if the transferor provides evidence that they have a medical condition which would prevent that person from participating in the business for a period of one year or longer.

*Commentary:* Most family business transfers occur as a result of the retirement of the business owner. An age restriction (or significant health issues) would be one indicator that the transfer is being made for bona fide non-tax purposes.

*b) Does the Taxpayer Have to Sell their Entire Interest in the Subject Corporation?*

For the taxpayer to take advantage of the exception from section 84.1, "qualified individuals" in combination with arm's-length and non-affiliated persons must control the subject corporation after the sale of the shares by the taxpayer. As well, within a three-year period of time the taxpayer must have disposed of any remaining shares in the subject corporation to "qualified individuals" in combination with arm's-length and non-affiliated persons.

*Commentary:* The exception is designed to assist with the retirement and business succession planning for the current owner(s). Therefore, the current owner(s) must give up control of the business to the "next generation" as part of the sale transaction to benefit from the exception. However, as is the case with many arm's-length purchase transactions, it is important that the current business owner(s) be allowed to participate in the operations of the business for up to a period of three years after the initial transfer of control to assist with a successful transition to the new owners.<sup>24</sup>

*c) Who Can Own the Purchaser Corporation?*

"Qualified individuals" must own over 50% of the votes and value of the purchaser corporation. All other shareholders of the purchaser corporation must deal at arm's length with the qualified individuals and the subject corporation, and not be affiliated with the subject corporation.

*Commentary:* The exception from section 84.1 should apply not only on a direct sale to qualified individuals (to permit hard basis for the full purchase price), but also to a sale to a purchaser corporation controlled by qualified individuals.

*d) Who are Qualified Individuals?*

Qualified individuals would be defined to be any of the taxpayer's children and grandchildren who are over the age of 17. As well, nephews/nieces and grandnephews/grandnieces of the taxpayer who are over the age of 17 would be qualified individuals.<sup>25</sup>

*Commentary:* The exception from the application of section 84.1 would not include transfers to siblings, grandparents, a spouse (or related entities) or any trust.

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<sup>24</sup> Ibid.

<sup>25</sup> This to avoid the Canada Revenue Agency making a factual determination that a nephew/niece or grandnephew/grandniece is factually not dealing at arm's length with the taxpayer.



*e) What Restrictions Apply to the Subject Corporation?*

The shares of the subject corporation must be qualified small business corporation shares, or shares of the capital stock of a family farm or fishing corporation, as those terms are defined in section 110.6 of the Act.

*Commentary:* The exception would therefore not apply to shares which don't qualify for the lifetime capital gains exemption.

*f) What is the Extent of the Exception?*

The exception would apply to the full amount of the gain realized on the disposition of the shares of the subject corporation.

*Commentary:* We don't believe it would be appropriate to "claw back" or eliminate the exception based on the "size" of the corporation. As well, we don't feel there should be a limitation based on the amount of the lifetime capital gains exemption being claimed or the amount of capital gain in excess of the amount of the lifetime capital gains exemption.

*g) What Type of Consideration Does the Exception Apply to?*

The exception would apply only to cash proceeds or prescribed debt received on the sale of the subject shares. Where debt is involved, the loan must have reasonable terms for repayment.

*Commentary:* The exemption would not be available on that portion of the proceeds that represent shares in the purchaser corporation or any related corporation.

*h) Does the Exception Require an Independent Valuation?*

We don't believe there should be a requirement for an independent valuation of the shares being sold. Instead, we recommend that claiming the exception would need to be reported in the taxpayer's return in the year of disposition.

*Commentary:* The requirement to have an independent valuation adds an additional layer of cost, complexity and time that we don't feel is required. Instead, the Canada Revenue Agency (CRA) would be put on notice that the exception from section 84.1 is being claimed (through the filing of an election with the corporate tax return for the year of the transaction), placing the CRA in the position where it can review the transaction to ensure that all requirements are satisfied, and that the sale transaction has taken place for fair market value, as it would in the normal course.

*i) Can the Taxpayer also Claim a Capital Gains Reserve?*

The capital gain arising on the sale of the shares should be treated like any other capital gain and a reserve can be claimed where the proceeds of disposition of the property are payable after the end of the year as set out in the Act.<sup>26</sup>

*Commentary:* Where the exception to section 84.1 applies, the normal rules applicable to the determination of capital gains and the reporting of such gains would apply.

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<sup>26</sup> Subparagraph 40(1)(a)(iii) and subsection 40(1.1) of the Act.



*j) Would There be Specific Anti-Avoidance Rules?*

We would support the inclusion of anti-avoidance rules similar to those included in the abandoned draft legislation which provided an exemption from capital gains tax with respect to certain arm's-length dispositions of shares in private corporations and real estate where the proceeds are gifted to a registered charity,<sup>27</sup> with appropriate modifications.

*Commentary:* We believe that it would be appropriate to “reverse” the benefits of the exception from section 84.1 if there are certain arrangements or transactions that result in the vendor directly or indirectly gaining control of the subject corporation within a specified timeframe.

**Conclusions**

CALU believes that the rules in current section 84.1 create an unfair tax bias that, in the future, will result in an increasing number of small businesses being sold to arm's-length purchasers, not because this is in the best interests of the owner, his or her family, or the business itself, but to minimize the tax consequences to the owner of such a sale. We are therefore recommending that section 84.1 be modified to provide an exception in situations where the owner wants to pass ownership and control to the next generation and prescribed conditions are met.

We look forward to having a dialogue with the government and the Department of Finance on how these changes can be implemented to preserve family owned businesses while minimizing unintended negative tax consequences.

Yours truly,



Gilles Chevalier  
Chair of the Board



Guy Legault  
President

cc: Elliot Hughes, Deputy Director, Tax Policy, Office of the Minister of Finance  
Richard Maksymetz, Chief of Staff, Office of the Minister of Finance  
Andrew Marsland, Senior Assistant Deputy Minister, Tax Policy Branch, Finance Canada  
Justin To, Deputy Director of Policy, Prime Minister's Office

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<sup>27</sup> Finance Canada, July 31, 2015.



## APPENDIX A

**Letter Dated September 12, 2017**  
**by Howard Johnson, MBA, FCPA, FCA, FCMA, FCBV, CPA, CFA, ASA, CF, C.Dir.**  
**1243 White Lane, Oakville, ON L6M 2T7**

By e-mail

September 12, 2017

Conference for Advanced Life Underwriting Suite 504 – 220 Duncan Mill Road North York, ON M3B 3J5

Attention: Mr. Kevin Wark

Re: Finance Consultation Paper

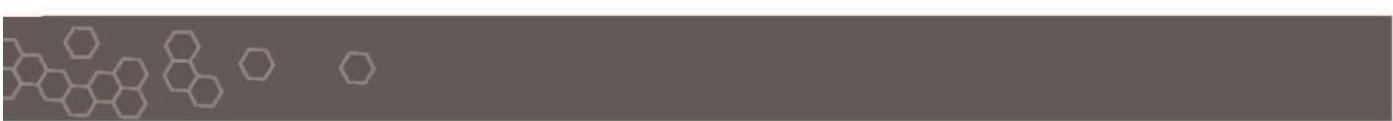
Dear Mr. Wark:

I understand that the Conference for Advanced Life Underwriting (CALU) is preparing a submission in response to a consultation paper issued by the Department of Finance – Canada (the “Finance Consultation Paper”) in respect of the taxation of intergenerational business transfers. You have asked me, in my capacity as an expert in the acquisition and divestiture of Canadian privately-held businesses, to comment on certain elements of the Finance Consultation Paper.

Specifically, you have asked for my professional opinion whether, in the context of arm’s length transactions, it is common for the vendor to:

- retain a financial interest in the transferred business; and
- participate in the management and operations of the transferred business.

A brief overview of my background and qualifications is attached to this letter. I understand that the contents of this letter may be used in CALU’s submission to the Department of Finance – Canada in respect of the Finance Consultation Paper.



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### Continued Financial Interest

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- the sale to a private equity firm. Such purchasers normally prefer that the vendor retain an equity position in the transferred business to align the interests of the parties. In some cases, the vendor may retain a majority equity position, although their ability to unilaterally control the business is subject to the provisions of a shareholder agreement;
- corporate buyers or individual investors who prefer to acquire a majority equity stake in the business. Such a transaction structure reduces the initial cash outlay for the purchaser and creates an economic incentive for the vendor through a put-call provision in respect of the retained equity interest; and
- a sale of the business to arm's length management, who may have limited financial resources and must acquire the shares over time.

In lieu of, or in addition to, retaining an equity interest, many arm's length transactions involve the vendor retaining a debt obligation against the transferred business. The obligation to the vendor is normally structured as a promissory note (or retractable preferred shares) which is subordinated to other obligations in the business. Such transaction structures (commonly referred to as a "vendor takeback") are frequently used in the acquisition of small and medium-sized private companies where the purchaser (often another small private company or individual) cannot secure sufficient financial resources at the closing date. The promissory note (or series of notes) may extend for several years following the transaction.

### Continued Management Participation

It is very common for the vendor to continue participation in the management and operations of the transferred business. In fact, it is unusual for the vendor of a privately-held company to make a "clean break" at the closing date of the transaction. As a condition to the transaction, purchasers normally insist that the vendor enter into a management or consulting agreement to help facilitate the transition, particularly with respect to proprietary know-how, employee morale and customer relationships.

The duration and responsibilities of the vendor under the management or consulting agreement depends on numerous factors, including the nature of the business itself, the vendor's involvement in the business prior to the transaction, the experience and capabilities of the management team, and the



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vendor's health and personal circumstances. Where the transaction is structured such that a portion of the purchase price is contingent on the future operating results of the business (i.e. an earnout), the vendor normally insists on their continued involvement in the business and their ability to manage the business in a way that maximizes the likelihood of achieving the earnout metrics.

#### Summary

Every open market transaction is unique and influenced by a variety of factors. However, based on my professional experience as an advisor to buyers and sellers of Canadian privately-held companies, in my opinion:

- vendors often retain a financial interest (equity and/or debt) in the transferred business; and
- vendors usually continue their participation in the management and operations of the transferred business for an agreed transition period.

I would be pleased to answer any questions that might arise from this letter.

Yours truly,

Howard E. Johnson 416-597-4500 [howard.johnson@duffandphelps.com](mailto:howard.johnson@duffandphelps.com)



## Attachment

### Brief Biography

#### **Howard E. Johnson, MBA, FCPA, FCA, FCMA, FCBV, CPA, CFA, ASA, CF, C.Dir.**

Howard is a Managing Director in the Mergers & Acquisitions group at Duff & Phelps in Toronto. Duff & Phelps is a global valuation and corporate finance firm, with over 2,400 professionals in 70 countries. Previously, Howard was the co-owner and Managing Director of Campbell Valuation Partners Limited and its sister firm, Veracap M&A International Inc., which were sold to Duff & Phelps in 2016.

For over 20 years, Howard has been advising business owners and executives of Canadian privately-held companies on acquisitions, divestitures, financing and valuation. He also serves as an expert witness on valuation matters before the courts, often acting on behalf of the Canada Revenue Agency and the Department of Justice – Canada.

Howard is the author of 9 books on the subjects of business valuation and corporate finance, including *Selling a Private Company*, 2nd ed. (Chartered Professional Accountants of Canada, 2014). He is a frequent speaker on mergers & acquisitions at conferences across Canada. Howard has also served on public and private boards, including past Chair of M&A International (a global mergers & acquisitions organization), past Chair of the Society of Management Accountants of Ontario, and a member of the Public Accountants Council for the Province of Ontario.

Howard holds a Bachelor of Commerce degree from Concordia University (Governor General's Award – 1988), a Graduate Diploma in Public Accountancy from McGill University (Kenneth F. Byrd Prize, 1989) and a Master of Business Administration from McMaster University (D.M. Heddon Gold Medal, 1992). Howard is a Fellow of the Chartered Professional Accountants of Canada (Fellow of the Institute of Chartered Accountants of Ontario and Fellow of the Society of Management Accountants of Ontario) and a Fellow of the Canadian Institute of Chartered Business Valuators. He also holds the designations of Certified Public Accountant (Illinois), Chartered Financial Analyst, Accredited Senior Appraiser, Corporate Finance qualification and Chartered Director.

