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CESTNICK

TAX MATTERS

Naughty or nice: Keeping your business in the family requires following the rules

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I had dinner recently with my friends, William and Veronica, who plan to hand their business to their daughter for Christmas. For years, our tax law put parents transferring a business to their kids on the naughty list, taxing them more than if they'd sold it to a stranger. Now, the taxman will move them to the nice list – if they play by the rules.

The old rules

If you sell shares of a qualified small business corporation to a stranger, you can typically shelter the capital gain with the lifetime capital gains exemption (the cap is $1.275-million as of 2026). You could sell directly to your child and claim the exemption, but they would have to pay for the shares with personal after-tax dollars, which is expensive. Sell to your child's corporation, and section 84.1 of the Income Tax Act could turn some or all of your gain into a higher-taxed dividend, with no capital gains exemption. Not exactly family-friendly.

The new rules

After a 2021 fix, Ottawa rewrote the rules for 2024 onward. You can now sell shares from a qualifying small business, farm or fishing corporation to a company controlled by adult children – including stepchildren, children-in-law, grandchildren, nieces and nephews – and report a capital gain. The catch? You have to pick one of two paths and stick to it.

Ten moves for employees to save tax before year-end

You can chose an "immediate" transfer, which means giving up legal and practical control at closing. The alternative is a "gradual" transfer, which means giving up legal control at closing while keeping some influence. Either way, you and your spouse generally can't hold half or more of any class of shares after closing – except qualifying non-voting preferred shares – and within three years hold nothing but those preferred shares.

You'll then have three years (the immediate path) or five (the gradual path) to hand over management for good. On the gradual path, within 10 years, what you still hold – shares, plus any money the kids' company owes you – must be worth no more than 30 per cent of your shares' value at the time of sale (50 per cent for farm or fishing corporations).

Your kids must keep control of the purchasing corporation (for up to three years for the immediate path and 10 years on the gradual path), the business must stay active, and at least one child must be involved on a "regular, continuous and substantial basis" for at least three years (immediate) or five to 10 (gradual). Also, you and the kids must jointly file Form T2066 by your tax-filing deadline. Miss it, and you could lose capital gains treatment, meaning your gain will be treated as a higher-taxed dividend.

Yeah, I know it's complicated.

The benefits

William and Veronica's business is worth $5-million. Assuming they're entitled to the lifetime capital gains exemption, selling to their daughter's holding company could shelter $1.275-million each. At Ontario's top rates, the tax would be about $655,700, compared with about $2,387,000 if it were all taxed as non-eligible dividends. Their daughter's company can pay with profits not yet taxed in her personal hands.

Five key deadlines to cut your 2026 tax bill

Watch out for the alternative minimum tax, though. On a gain this size, it'll likely add about $300,000 upfront, but it's recoverable over seven years if you have enough income. And if you're paid over time, a capital gains reserve can spread the gain over 10 years and reduce the alternative minimum tax.

The pitfalls

William will find it hard to let go. Giving advice is fine, but the taxman says that if you're still a director when your three- or five-year window closes, you haven't handed over management. You generally get one shot per business, so selling in stages won't work – only the first sale qualifies. Selling to several children's corporations? Do it simultaneously. Vendor financing is fine, but loan terms that leave you calling the shots could jeopardize an immediate transfer's tax benefits. Kids who sign Form T2066 could be on the hook for your extra tax if things go sideways. And the Canada Revenue Agency generally gets three (immediate) or 10 (gradual) extra years to reassess you.

The other options

There are other ways to transfer a business to the kids. An estate freeze, often with a family trust, can lock in your value today, shift future growth to your kids and potentially multiply the lifetime capital gains exemption. If you're gifting shares outright, you'll generally be deemed to have sold those shares at fair market value – with no cash to pay the tax. And beware of bargain-priced sales: you could be taxed on the full fair market value while your kids' cost base stays at the lower actual price, which will create a double-tax problem. If your kids aren't the right successors, consider an employee ownership trust (now with a permanent $10-million capital gains exemption) or a third-party sale.

The human issues

Taxes can be managed. But is the business your pension? Can you make ends meet if payments are delayed? Is your child ready to lead? How will you treat your other kids fairly? Does your child need a marriage contract? And can you really let go? Talk these through first.

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