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The Influence of Tax Factors on Québec and Other Canadian SME Transfers

Research Report

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GLOSSARY

Business succession represents an economic and social philosophy, a desire shared by an SME owner and a successor to ensure the sustainability of a viable SME through the transfer of power, leadership, knowledge and ownership of the SME.

Capital gain is the difference between the proceeds of disposition (sale price) and the adjusted cost base (cost) and sale-related expenses.

Capital loss (or tax loss) results from the sale of property or investments for less than they were paid for, which allows a corporation or taxpayer to reduce the capital gains tax base.

External successor is a non-family successor who acquires shares or assets of a corporation. The term includes someone who works in the SME but is not related to its owner (also known as an internal successor).

Family successor represents a successor with a non-arm's length relationship with the owner (e.g., related by blood, marriage, adoption or common-law partner). The technical interpretation on the part of tax authorities of the *non-arm's length relationship* between the owner and the successor is relatively broad (Charest, 2019), and may even include an employee who is the "guiding spirit" exercising de facto control of the SME.

Inclusion rate Most income (employment, retirement, interest, rent, etc.) is fully included in a taxpayer's taxable income. The ***inclusion rate*** is therefore generally 100%. In Québec and the rest of Canada, capital gains benefit from preferential treatment in the form of a reduced inclusion rate, i.e. only 50% of the capital gains realized are considered in the calculation of the taxpayer's taxable income.

Lifetime capital gains exemption, also known as the **capital gains deduction** (CGD), is a tax deduction that applies in the calculation of an individual's taxable income. This measure, which exists at the federal and Québec provincial levels, is an incentive for investment and risk-taking in SMEs as well as the development of farming and fishing corporations. This measure was adopted in 1985 to help owners of SMEs and farming or fishing corporations save for their retirement. As a result, an individual may have a low taxable income but a high net income.

SME owner owns the majority of the shares of a corporation's share capital. He or she is the respondent to the following question about his or her intentions to: "[…] transfer to family member(s) without money changing hands?" or "sell to family member(s)?" See questions J9 and J10 at https://www23.statcan.gc.ca/imdb/p3Instr.pl?Function=assembleInstr&lang=fr&Item_Id=438230.

Taxable capital gain (TGC) is the amount included in the calculation of a taxpayer's net income. The TCG represents the capital gain multiplied by an inclusion rate. For the period under study, this inclusion rate was ½.

Transfer of ownership Although there are two approaches to the transfer of ownership of an SME from an owner to a successor, namely the sale of shares and the sale of assets, the first is preferentially used as part of the tax calculations in this study.

HIGHLIGHTS

Economic contribution of capital gains generated by SME transfers

In Québec alone, the capital gains that would be generated by the fulfilment of all SME transfer intentions could reach the $15.7 billion mark over a period of five years (2017-2022). These transfer intentions among Québec SMEs would annually generate the equivalent of 1.4% of the total remuneration for all employment in Québec in 2017, which represents a total remuneration equivalent to that of all employment in the real estate and rental and leasing services industries. At the same time, we note that SME transfers in the other Canadian provinces annually represent a little over $41 billion in capital gains over a period of five years, i.e. slightly more than $8.2 billion per year. Across Canada, the value of the anticipated capital gains from intended SME transfers corresponds to a little over $11.4 billion annually.

Overall tax impact of the existing rules on SME owner income

Our findings suggest that the Québec SME owner population that intends to transfer to family members between 2017 and 2022 could save $245.6 million to a little over $1.04 billion, if it were eligible for the same capital gains deduction as the one extended to Québec SME owners who are thinking about transferring their businesses to external successors. For the first group, our estimates show that, altogether, 33,866 Québec owners would reap over $5.3 billion if they were eligible for the same capital gains deduction as the group that includes owners who prefer to transfer to external successors.

Estimated average additional income for SME owners who are ineligible for the capital gains deduction

For the 10,414 Québec owners who intend to transfer to family members, we estimate average taxable capital gains of $91,567 in 2017. This amount of $91,567 thus serves as the basis from which to calculate additional taxable income that would be proportional to the owner's marginal tax rate in the event that he or she is unable to satisfy the existing eligibility conditions.

Estimated fiscal inequity

For the 10,414 Québec owners who intend to transfer to family members, our estimates suggest that the ineligibility for the capital gains deduction represents potential additional income of up to $1.96 billion over a period of five years. These owners could save $245.6 million to a little over $1.04 billion if they were eligible for the same capital gains deduction as those who prefer to transfer to external successors. These estimates show that the fiscal inequity associated with family SME transfers represents around 16.4% of the capital gains that can be generated by a transfer in Québec and 17% in the other Canadian provinces.

Contribution of governments to the economy by easing the tax rules associated with capital gains

According to our estimates, the tax relief granted to owners who transfer their SMEs represents a little over $2.9 billion for both levels of government, which would be distributed over a period of five years (2017-2022), i.e. approximately $580 million annually.

TABLE OF CONTENTS

INTRODUCTION 2

1. CONTEXT 4
   1.1 Determining factors for the tax analysis 6
   1.2 Tax calculation scenarios for SME owners 8

2. METHODOLOGY 10

3. ANALYSIS AND RESULTS 13
   3.1 Estimates of the tax impact of SME transfer intentions in Québec 14
   3.2 Estimates of the tax impact of SME transfer intentions in the other Canadian provinces 17

4. DISCUSSION 19

5. CONCLUSION AND RECOMMENDATIONS 21

LIST OF REFERENCES AND BIBLIOGRAPHY 25

LIST OF APPENDICES
APPENDIX 1: Ratio of Market Value to Book Value, 2017 28
APPENDIX 2: Marginal Tax Rates 2017 29

LIST OF FIGURES
FIGURE 1: The Influence of Tax Factors Related to SME Transfers 7

LIST OF TABLES
Table 1: Transfer Intentions of SME Owners 5
Table 2: SME Owner Intentions Based on Transfer Type 6
Table 3: Theoretical Calculations of Sales of Shares (QSBCS) 9
Table 4: Theoretical Calculations of Sales of Shares (QFFP) 9
Table 5: Number and Average Sales of SMEs Based on Transfer Type for All Industries in Québec 12
Table 6: Number and Average Sales of SMEs Based on Transfer Intentions for All Industries in the Canadian Provinces Other Than Québec 13
Table 7: Taxable Income Based on Transfer Intentions (All Industries in Québec) 16
Table 8: Additional Taxable Income Based on Transfer Intentions (All Industries Excluding Farming and Fishing in Québec) 17
Table 9: Additional Taxable Income Based on Transfer Intentions (All Industries in the Canadian Provinces Other Than Québec) 18

"The lifetime capital gains exemption was introduced in 1985 with definite and relatively simple objectives. [...] As the exemption gradually became more limited and targeted following its introduction, substantial complexities were added to the tax system, until the exemption developed into one of the most difficult and complicated areas of the tax law applicable to a broad range of individual taxpayers." James R. Wilson, McCarthy Tétrault (1995).

"[...] In conclusion, a tax specialist is required to assist both the exiting entrepreneur and the successor."
Jean-François Thuot, PWC (Translated from Cadieux et al., 2020).

INTRODUCTION

Every year, thousands of SME owners in Québec and the Rest of Canada (ROC) face the difficult choice of transferring their business to a family member or outsider in order to benefit from a lifetime capital gains tax deduction. Given that the amount of the tax deduction can reach up to four or five hundred thousand dollars, based on the value of the business, the decision to transfer to a family member can be agonizing both financially and psychologically. According to Statistics Canada's *Survey on Financing and Growth of Small and Medium Enterprises, 2017 (SFGSME)*, more than 6,700 SME owners in Québec, and more than 18,000 in the ROC, weigh these two options every year.

In recent years, the impact on SME transfers of tax provisions that determine eligibility for this deduction has brought its merits to the forefront of public debate (Charest, 2019; Godbout, 2017; RCGT/CCIQ, 2019; RCGT, 2010a,b; UPA, 2014). Many are critical of these provisions, which were implemented to limit tax avoidance, and which disadvantage a transfer to a family member when compared to an external successor. Several experts are of the opinion that the conditions that determine eligibility for this tax deduction are complex and often impenetrable for the average citizen. The advice of tax specialists is necessary, but expensive. In short, tax rules do not make things simple for SME owners who wish to make an informed choice between a transfer to a family member or an external successor to ensure the sustainability of their business.

What is most surprising is that this situation is well known to public authorities in both Québec City and Ottawa. Even before it was introduced in 1985, this tax deduction had been the subject of much criticism (Wilson, 1995), and its unintended negative effects on entrepreneurial dynamism had been widely anticipated in the reports of the 1966 Royal Commission on Taxation of the Government of Canada (the Carter Commission) and the 1965 Commission royale d'enquête sur la fiscalité au Québec (the Bélanger Commission). Thirty-five years after this tax deduction was introduced, it has become clear that those who feared that this measure would stimulate creativity among tax planners rather than among SME owners were not entirely off base. The backlash of increasingly complex administrative and regulatory provisions brought in to prevent all sorts of tax evasion manoeuvres has eventually bogged down the legislators' good intentions. As Wilson (1995, p. 206) has pointed out: "*The debate as to whether or not the capital gains deduction is good tax policy continues and may never be resolved in the absence of clear empirical evidence that it induced the desired business and investment activity*."

The root of the problem is that eligibility for this tax deduction, which is identified almost interchangeably as the *capital gains deduction* or the *lifetime capital gains exemption*, violates the *principle of tax neutrality* in many cases of legitimate SME transfers.

One of the most often mentioned barriers to undertaking an SME transfer project concerns certain tax rules that discourage transfers to family successors in favour of external successors. This is despite the low success rate associated with this second type of transfer when compared to family transfers (Bastié,

Cieply and Cussy, 2018; OSEO, 2007). Given that the capital gain generated by a transfer to a family member is not eligible for the lifetime capital gains exemption, the resulting net income encourages SME owners to sell their shares to an external successor. Dollar for dollar, a person who transfers his or her SME to a family member pays more income tax than a person who transfers to an external successor. The current tax provisions that apply to the lifetime capital gains exemption are, therefore, *inequitable* to SME owners when they legitimately transfer their business to a family member.

Because the tax provisions concerning eligibility for the capital gains deduction are complex, the impact of these provisions on SME transfers, for the time being, remains theoretical, conceptual, or anecdotal (Deloitte, 2017). And the public debate on the inequitable treatment of family SME transfers continues without an understanding of the scope of the problem and its effects on the entrepreneurial dynamism of SMEs.

The purpose of this study is, therefore, is to quantify the scope of the tax inequities for SME owners when they wish to transfer their business to a family successor. To do so, we developed a theoretical accounting model and used a new linked micro-database from Statistics Canada to estimate the market value of SMEs, the capital gain and the average additional taxable income of SME owners based on their transfer intentions.

Our estimates show that, in Québec alone, the total annual sales of SMEs whose owners intend to transfer to a family member was $31.7 billion in 2017, compared to $35.6 billion for those who were considering other types of transfers, whereas they accounted for only 30.7% of all SME transfers. In addition, total capital gains generated by all SME transfer activities can reach up to $15.7 billion over a five-year period (2017-2022) in Québec, of which nearly 41% would be a result of family transfers. Given that transfers to family successors are not eligible for the capital gains deduction, these transfers represent an additional tax burden ranging from $245.6 million to $1.04 billion over five years for their owners, based on the marginal income tax rates. Lastly, our estimates suggest that SME owners who prefer to transfer to external successors can still expect capital gains that are about 30% lower than they would obtain from a family transfer.

Our estimates also cover SMEs in all the other Canadian provinces. Excluding Québec SMEs, the total annual sales of SMEs whose owners intended to transfer to a family member was $43.4 billion in 2017, compared to $98.5 billion for those who were considering other types of transfers, even though they only represented 25.3% of all SME transfers. The total capital gains generated by all SME transfer activities outside Québec could reach $41.2 billion over a five-year period, 31% of which would come from family transfers. Given that transfers to family successors are not eligible for the capital gains deduction, family transfers therefore represent an additional tax burden of $505.6 million to $2.2 billion over five years for their owners, based on their marginal income tax rates.

While Québec and other Canadian SMEs are dealing with the severe economic consequences of the COVID-19 pandemic, our estimates highlight the urgency with which public authorities must rectify the negative side effects of these tax provisions.

In 2015 and 2016, Québec eased some of the tax provisions that apply to SME transfers in order to re-establish neutrality with the *Québec Taxation Act* (QTA) (Gouvernement du Québec 2015d; 2017). Nevertheless, criticism of the inequitable treatment of transfers to family successors continues to this day. One such criticism points to the fact that the relaxed measures introduced in 2015 by the Québec government are difficult to apply to all eligible SMEs (Charest, 2019). Others complain that the federal

Department of Finance has yet to amend section 84.1 of the federal *Income Tax Act* (ITA), which maintains a perception of inequity when Québec and federal tax rules are compared (Charest, 2019).[1]

Given the loss of income stemming from these relaxed tax provisions that apply to family SME transfers reported by the Québec government in the 2015-2016 and 2016-2017 provincial budgets, which were estimated at $5 million for 2016 and $15 million for subsequent years (Gouvernement du Québec, 2015d, 2016), economic and fiscal benefits in the hundreds of millions of dollars from family SME transfers far exceed the loss of tax revenue from the relaxed tax provisions and are detrimental to the economy in both Québec and the ROC.

This report is presented as follows. Firstly, we review the transfer intentions of SME owners and the tax rules that prevent owners who would prefer to transfer to family members from claiming a capital gains deduction in Québec and the ROC. Secondly, we outline the methodology used to estimate the average capital gains of owners who intend to transfer to a family successor over the next five years. We then present our main findings on the anticipated average additional income of SME owners in Québec, as well as our estimates of the tax impact of intentions to transfer to family successors in the other Canadian provinces. Lastly, we conclude this report by issuing our recommendations and final remarks.

1. CONTEXT

In the last twenty years, the issue of business succession has been a subject of concern for public policy makers, professionals and researchers in Québec, the ROC and other developed countries (Corner and Ratté, 2017; Cossette and Mélançon, 2010; Duhamel et al., 2019; OECD, 2018; Shore Consulting, 2018). This can be explained by, among other things, the growing number of SME owners who intend to transfer their business for various reasons, such as those related to age (retirement, health issues, etc.).

For example, between 2007 and 2017, the population of owners who intended to transfer their SMEs increased by 5% in Québec and 3.5% in all of Canada to reach 23.5% in Québec and 19.5% in all of Canada, which represents more than 33,000 Québec SMEs and 120,000 SMEs to be transferred in all of Canada between 2017 and 2022 (Duhamel et al., 2019). Out of a desire to maintain the economic vitality of cities and regions, public authorities are looking for the best strategies to ensure the sustainability of existing SMEs, especially those that are the most viable (Canada, 2017; Canada, 2019a, CCMM, 2014; Charest, 2019; Cruz, 2018; RCGT, 2010a, b; Sideris, 2018a, b).

Table 1 presents the number of SMEs likely to be transferred before 2022 according to Statistics Canada's *Survey on Financing and Growth of Small and Medium Enterprises, 2017*. In 2017, 23.5% of Québec SME owners stated their intention to transfer their SMEs before 2022, compared to 19.4% in Canada as a whole. The growth of this phenomenon in only 10 years can be explained by the aging of the SME owner population. More specifically, a

Estimated number of SMEs to be transferred between 2017 and 2022:

- *33,866 in Québec;*
- *90,006 in Canada excluding Québec;*
- *123,872 in Canada.*

[1] The issue has been the subject of a federal bill (Office of the Parliamentary Budget Officer, 2017). It reappeared at the federal level on December 19, 2019 in mandate letters from the Minister of Agriculture and Agri-Food and the Minister of Finance who were assigned the responsibility to work on "... tax measures to facilitate the intergenerational transfer of farms" (Canada, 2019a, 2019b).

study by Duhamel et al. (2019) has revealed that in Québec, transfer intentions generally increase with the age of SME owners, increasing from 14% for those aged 40 to 49 to 26% and 39% for owners aged 50 to 64 and 65 and over, respectively.

Table 1
Transfer Intentions of SME Owners

Intentions of owners to transfer their SMEs between 2017 and 2022	Number and % of SME Population, 2017					
	Québec		Canada, excluding Québec		Canada	
	N	%	N	%	N	%
Do not intend to transfer their SME	98,406	68.4%	354,082	71.7%	452,488	71%
Intend to transfer their SME	33,866	23.5%	90,006	18.2%	123,872	19.4%
Intend to close their SME	9,245	6.4%	41,176	8.3%	50,421	7.9%
Other intentions	2,315	1.6%	8,453	1.7%	10,767	1.7%
Total weighted number of SMEs	143,832	100%	493,716	100%	637,548	100%

Table 2 presents the owners' intentions based on the type of transfer under consideration. It should be noted that nearly 31% of Québec SME leaders hold a preference for a family transfer, while this proportion was a little over 25% in the other Canadian provinces. A number of arguments could explain this discrepancy in the intention to transfer to family members.

Firstly, according to Duhamel et al. (2019), a greater proportion of Québec SME owners are themselves successors of a business. Some may wish to repeat the positive experience of transferring to a family successor. Secondly, the relaxed tax measures introduced by the Québec government in 2015 for various business segments could explain the higher popularity of family transfers. Thirdly, other factors such as the sectoral composition of Québec SMEs may lend themselves more easily to family transfers, e.g. farming and fishing, given the capital gains deductions associated with these segments. Thus, the higher the number of SMEs that operate in these segments, the higher the number of owners who want to transfer to a family successor. Fourthly, it would be reasonable to assume that the intentions toward this type of transfer were expressed after previous SME sales from which the owners had already benefited from the capital gains deduction. Lastly, this phenomenon could also be explained by the low market value of the SME on the external transfer market, which means that there is relatively little financial penalty for owners who sell their shares or assets, especially if they do not depend on this sale to replenish their retirement funds.

Table 2
SME Owner Intentions Based on Transfer Type

Type of transfer being considered by SME owners	Number and % of SME Population, 2017					
	Québec		Canada, excluding Québec		Canada	
	N	%	N	%	N	%
Family	10,414	30.7%	22,758	25.3%	33,172	26.8%
Other types of transfers	23,453	69.3%	67,248	74.7%	90,700	73.2%
Total weighted number of SMEs	33,866	100%	90,006	100%	123,872	100%

1.1 Determining factors for the tax analysis

The tax analysis of an SME transfer is represented by the intersection of the three determining factors in Figure 1: the characteristics of the owner (age, income, children, etc.), those of the SME (capital structure, number of employees, business segment, etc.) and the context of the transfer (interest rates, tax rates, economic conditions, etc.). From this perspective, we analyzed two of the main tax factors that ultimately determine the net tax-free funds of the transfer for SME owners: the *lifetime capital gains exemption limit*, which depends on the nature of the property available to the SME based on its business segment, and the *non-arm's length relationship* between the owner and the successor. We are aware that there are other factors, but as we will show in the following section, these two factors have a significant impact on the net tax-free funds of SME owners.

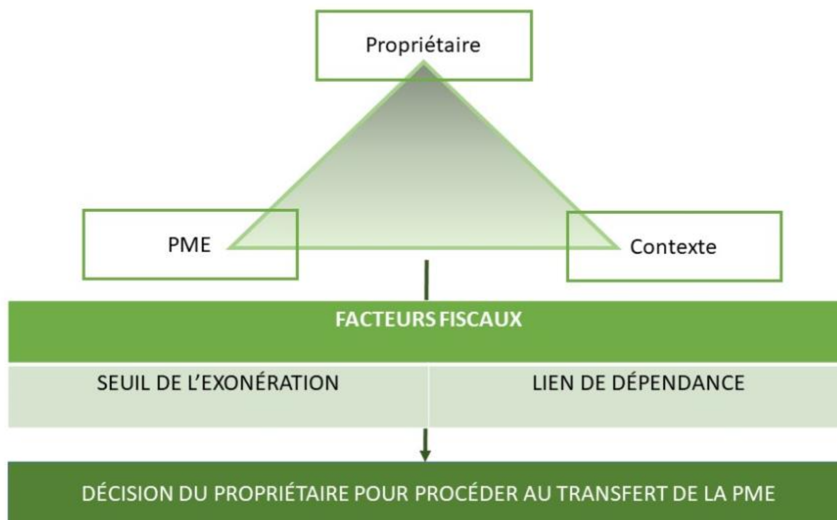
The first factor, the exemption limit, sets the ceiling on the *capital gains deduction* granted to owners of an SME when it is sold.[2] Sections 110.6 of the ITA and 726.7 of the QTA grant a taxpayer a lifetime exemption for the capital gain realized from the disposal of qualified small business corporation shares (QSBCS) or qualified farm or fishing property (QFFP) within the meaning of section 726.6.1 of the QTA. In 2017, the amount of the lifetime capital gains exemption was $835,716 for QSBCSs and $1,000,000 for QFFPs. For example, where an SME operates in the farming and fishing industries within the meaning of section 726.6 of the QTA, an owner may transfer to his or her children or grandchildren the share capital of a family corporation tax-free up to $1,000,000. In the interest of simplicity, we will represent our estimates of the tax calculation of the various amounts of the capital gains exemption limit based on SME industry.

The second factor relates to the *non-arm's length relationship* between the SME owner and the successor. As explained by Charest (2019), sections 84.1 of the ITA and sections 517.1 et seq. of the QTA impose restrictions that prevent a shareholder from using the capital gains deduction and the tax-free allowance (for pre-1972 capital gains) when they receive a tax-free distribution of capital rather than a non-arm's length taxable dividend. Given that the technical interpretation by tax authorities of the non-arm's length relationship between the owner and the successor is relatively broad (Charest, 2019), and could even include an employee who is the "guiding spirit" exercising "*de facto* control" ofthe SME, these tax rules

[2] Since the capital gain inclusion rate has been 50% since October 17, 2000, the lifetime capital gains *deduction* is one-half the amount of the exemption. The amount of the exemption has been indexed to the Statistics Canada inflation rate since 2014 for QSBCSs.

assume that any business transaction between persons with a "*de facto*" arm's length relationship is essentially a "surplus stripping" scheme.

Figure 1
The Influence of Tax Factors Related to SME Transfers
(French only)



Thus, even when it can be shown that the SME transfer is legitimate, the application of this tax provision has a negative side effect in making the capital gains deduction ineligible in the case of a family transfer. As a result, an owner has a certain tax advantage in selling the SME's shares to an external third party in order to benefit from the capital gains deduction because the tax on capital gains is usually lower than the tax on dividends.

The recognition of these unexpected effects on the sustainability of Québec SMEs has led to the introduction of a number of relief measures in terms of the technical eligibility conditions relative to sections 517.5.3 et seq. of the QTA in the case of family SME transfers by the Québec government since 2015 (Gouvernement du Québec, 2015d, 2016). Although these relief measures were initially granted to eligible SMEs in the primary farming, fishing and manufacturing industries in 2015, as of March 17, 2016, they have been extended to SMEs in all industries that meet certain objective criteria of "qualified shares" that determine whether the transfer is real (Charest, 2019; Gouvernement du Québec, 2017).

1.2 Tax calculation scenarios for SME owners

Technical conditions and tax terms can at times be impenetrable.[3] However, inequitable treatment of a transfer to a family successor does not necessarily equate to a huge financial loss for the owner. The interest shown by SME owners in this type of transfer suggests that the tax impact may not be so significant, given that the median after-tax income of Canadian families and non-family persons was $61,400 in 2018, roughly the same as it was in 2017.[4]

To understand the order of magnitude of the tax impact of a firm's eligibility for the capital gains deduction and the various deduction limits, Tables 3 and 4 illustrate the main components of the tax calculation in the hypothetical case of sales of shares of SMEs with qualified farm or fishing property (QFFP) and SMEs in other industries (QSBCS). To align with the reference year of the data on transfer intentions of Québec and overall Canadian SME owners that we used, the tax calculations presented were carried out for the 2017 tax year; the most recent reference year for the data. Tables 3 and 4 present these calculations based on three characteristics of a transfer: the business segment that determines the exemption limit; the sales of shares based on whether they qualify for the capital gains deduction (because of the non-arm's length relationship); and lastly, two possible values of the proceeds of disposition (PD) for an SME ($100,000 and $2 million).

Columns A and C in Tables 3 and 4 show that the gains realized on the sale of shares of an SME with an estimated market value of $100,000 (line 1) and an adjusted cost base of $1,000 (line 2) in 2017 was $99,000 (line 3) regardless of the industry. Columns B and D illustrate a similar calculation where an SME's market value was in the order of $2 million in 2017. From the gain, the owner's *capital gain* (CG) can be determined. The *capital gain* (line 5) is equivalent to the *gain* (line 3) on the assumption that no reserve was possible and that the full payment was made within the 2017 tax year. Since the *taxable capital gains* (TCG) is the amount included in the calculation of the owner's net income, the TCG (line 7) is the most important amount to understand the tax impact of the type of transfer with the capital gains deduction (line 8). The TCG is the product of the capital gain (line 5) and an inclusion rate (line 6) that has varied substantially over the last few decades.[5] Since this inclusion rate was 50% in 2017, the TCG (line 7) for SMEs with a market value of $100,000 and $2 million were $49,500 (columns A and C) and $999,500 (columns B and D) respectively, which represents half of the capital gains realized regardless of industry.

[3] According to Wilson (1995, p. S206), the *"The lifetime capital gains exemption was introduced in 1985 with definite and relatively simple objectives. […] On the contrary, the introduction of the exemption was accompanied by many complex rules designed to implement it in a precise manner and to prevent its misuse."*

[4] For more details on median household income data for Québec and all of Canada, https://www150.statcan.gc.ca/n1/daily-quotidien/200224/dq200224a-eng.htm.

[5] The inclusion rate was 0% before 1972 and gradually increased to 75% in 1990, then gradually decreased to 66.67% (February 28, 2000) and 50% since October 17, 2000.

Table 3
Theoretical Calculations of Sales of Shares

		QSBCS – Qualified SME Shares			
		Eligible for the CGD		**Non-Eligible for the CGD**	
		A	**B**	**C**	**D**
Proceeds of disposition (PD)	1	**100,000**	**2,000,000**	**100,000**	**2,000,000**
Adjusted cost base (ACB cost)	2	(1,000)	(1,000)	(1,000)	(1,000)
Gain (PD – ACB) (1-2)	3	99,000	1,999,000	99,000	1,999,000
Reserve (if deferred payment)	4	(0)	(0)	(0)	(0)
Capital gain (CG) (3-4)	5	99,000	1,999,000	99,000	1,999,000
CG inclusion rate (½)	6	½	½	½	½
Taxable capital gain (5 × 6)	7	49,500	999,500	49,500	999,500
Capital gains deduction (CGD)	8	(49,500)	(417,858)	(0)	(0)
Additional taxable income (7-8)	9	0	581,642	49,500	999,500

Table 4
Theoretical Calculations of Sales of Shares

		QFFP – Qualified Farm or Fishing Property			
		Eligible for the CGD		**Non-Eligible for the CGD**	
		A	**B**	**C**	**D**
Proceeds of disposition (PD	1	**100,000**	**2,000,000**	**100,000**	**2,000,000**
Adjusted cost base (ACB cost)	2	(1,000)	(1,000)	(1,000)	(1,000)
Gain (PD – ACB) (1-2)	3	99,000	1,999,000	99,000	1,999,000
Reserve (if deferred payment)	4	(0)	(0)	(0)	(0)
Capital gain (CG) (3-4)	5	99,000	1,999,000	99,000	1,999,000
CG inclusion rate (½)	6	½	½	½	½
Taxable capital gain (5 × 6)	7	49,500	999,500	49,500	999,500
Capital gains deduction (CGD)	8	(49,500)	(500,000)	(0)	(0)
Additional taxable income (7-8)	9	0	499,500	49,500	999,500

The importance of the eligibility conditions for the *capital gains deduction* (CGD) is illustrated in line 8 of Tables 3 and 4. Depending on the industry, in 2017, owners could benefit from a *lifetime capital gains exemption* of $835,716 for capital gains realized on the disposition of qualified small business corporation shares (QSBCS) and $1,000,000 for qualified farm or fishing property (QFFP). Assuming that the owners did not use any portion of the capital gains deduction (CGD) prior to the transaction, the CGD was available at 100% in 2017, if eligible. Given that the inclusion rate of the taxable capital gains is 50%, the capital gains deduction corresponds to exemption limits of $417,858 (QSBCS) and $500,000 (QFFP) depending on the SME's industry.

Considering the marginal tax rates (federal and provincial) that varied between 12.53% and 53.31% in 2017, SME owners who were not eligible for the capital gains deduction lost 6% to 27% of the capital gains realized based on their taxable income.

For an SME with $2 million in proceeds of disposition, the additional income for the owners is in the order of $120,000 to more than $500,000.

The tax impact of the eligibility conditions and the amounts allocated to the capital gains deduction based on the industry for SME owners becomes apparent in line 9 of the tax calculations in Tables 3 and 4. From the taxable capital gains, the *additional taxable income* (line 9) resulting from the sale of shares of an SME is determined by deducting from this amount the exemption limit (or ceiling) of the capital gains deduction for the 2017 tax year. For an SME that is eligible for the capital gains deduction and whose taxable capital gain is less than or equal to the capital gains deduction

ceiling, the additional taxable income is nil (line 9, column A). In this case, the owners retain 100% of the proceeds of disposition from the sale of their SME shares, with no taxes to pay.

In cases where the owners are not eligible for the capital gains deduction (columns C and D) (for example, because of a family connection with the successor), the entire taxable capital gain becomes additional taxable income. Owners must decrease the proceeds of disposition with the tax payable, according to the income tax tables in effect.

The tax calculations in these hypothetical cases are revealing, but the empirical question remains unanswered. How many of these theoretical cases are there in Québec and the ROC? How many SME owners are treated inequitably by these tax provisions? And, how much additional tax would they have to pay? The following sections describe the methodological approach we used to answer these questions as well as our main findings.

2. METHODOLOGY

To our knowledge, Statistics Canada's *Survey on Financing and Growth of Small and Medium Enterprises* (SFGSME) is the most important national survey that combines information on the relevant geographic and economic characteristics of SMEs in Québec and Canada as a whole with the demographic profile of their *majority owners*, i.e., those who hold the majority of the shares in an SME.[6] Since its original design as a pilot project in 2000, it has regularly been used to survey owners of Québec and other Canadian SMEs on the approach used to start up an SME, making a distinction between those who inherited or acquired the SME from those who started it from scratch (Duhamel et al., 2019).

For 2007 and 2017, the survey added a series of questions on the *business transfer intentions* of SME majority owners.[7] The 2017 national survey was carried out in partnership with a consortium of organizations led by Innovation, Science and Economic Development Canada. The data are based on responses from over 9,000 SMEs selected from Statistics Canada's Business Register, which is an administrative database of all SMEs that produce goods and services in Canada. The stratified sample for this survey is representative of the target population of 732,152 SMEs with at least one employee in Canada, including 163,307 SMEs in Québec. The target population excludes SMEs with no employees (e.g. self-employed workers) or those with more than 500 employees; SMEs with a gross revenue of less than $30,000; non-profit organizations (such as schools, hospitals and charities); joint ventures; and public organizations.[8]

In this study, we do not distinguish between majority owners and owners of a share of the capital stock of a corporation, even though there may be significant differences from a taxation standpoint, particularly in terms of the eligibility criteria for the capital gains deduction for shares of a corporation that operates a family farm corporation, a family fishing corporation or a corporation that operates an SME.

[6] From a strictly taxation standpoint, all owners of eligible shares of a corporation that operates an SME, a family farm corporation and a family fishing corporation are eligible for a capital gains deduction. The SFGSME data do not allow for an estimate of the distribution of capital gains based on shares in the business.

[7] The 2017 survey results cover 10 industry groups, 4 workforce sizes and 10 geographic regions. Data from this survey are also available for the 2004, 2011 and 2014 reference years.

[8] The survey's target population also excludes firms in certain industries. For more details, refer to the *Survey on Financing and Growth of Small and Medium Enterprises, 2017 – Methodology Report*.

Although the data from this survey provide information on the intentions of owners regarding the transfer of their SME, on their socio-demographic profile (age, gender, mother tongue), and on the SME's economic profile (workforce size, financing and innovation activities), this information cannot be used to estimate an SME's market value or proceeds of disposition. To estimate the proceeds of disposition of SMEs combined with the industry segment and the type of transfer contemplated by the owner, we therefore used a new experimental linked micro-database that matched the 2017 SFGSME with the Longitudinal Linkable File Environment (LLFE) file developed exclusively for this project by Statistics Canada's Canadian Centre for Data Development and Economic Research (CDER). It provides university researchers with direct access to experimental anonymous business micro-databases at Statistics Canada's head office in Ottawa only for projects deemed to be in the public interest.

The (weighted) average sales of $1,300,039 is the target population-weighted average of the total sales in 2017 of the 7,580 SMEs whose taxable capital gains were below $417,858 in 2017 based on the estimated proceeds of disposition in 2017 derived from the reporting of the value of net assets plus the market-to-book ratio of 1.51 in 2017.

Statistics Canada's LLFE contains a complete, up to date list with no duplicates of all companies listed in the Business Register (BR) in Canada since 2000. The LLFE is a longitudinal environment in which administrative data and business surveys can be linked on an experimental basis. The BR contains information on stratification, data collection and response profile for Canadian businesses that have a corporate income tax (T2) account with the Canada Revenue Agency. The LLFE contains a wealth of administrative data from the General Index of Financial Information, the Exporter Register, the Canadian Intellectual Property Office's Patent Services, and Business Innovation and Growth Support. In this study, we used anonymous administrative information from the Canada Revenue Agency's corporate balance sheets and used observations on the net assets of SMEs from the 2017 SFGSME.[9]

This database made it possible for us to observe not only the reported annual revenue of each SME in the 2017 SFGSME based on its transfer intentions, but more specifically to estimate the taxable capital gains that would have been reported. To estimate market value, we multiplied the net assets of each SME by the market-to-book value ratio obtained from a table in Statistics Canada's *International Investment Position*.[10] Thus, the proceeds of disposition are obtained by multiplying the book value of the net assets (shareholders' equity) of the SME's by the average of the quarterly market-to-book ratio of international investments, which was 1.51 in 2017 (see Appendix 1).

To facilitate the presentation of our estimates, we classified all SMEs based on two criteria. The first determines whether or not the owner's intentions correspond to a transfer to a family successor. Given that the presence of a non-arm's length relationship affects the eligibility of the sale of shares of the SME for the capital gains deduction, the comparison illustrates the tax impact of section 84.1 of the ITA. The second criterion determines whether or not the taxable capital gains exceed the 2017 capital gains deduction limit set forth in section 110.6 of the ITA. It is important to note that in our estimates of the taxable capital gain, we applied to each SME the 2017 deduction limit that corresponds to its industry

[9] For all the companies in our sample, we ensured that the balance sheet of net assets was exactly equal to the difference between the assets and liabilities reported by a company.

[10] This approach was used by the Office of the Parliamentary Budget Officer (2017) as part of a study to estimate the costs of a bill to amend the *Income Tax Act* in the case of a transfer of a small business or a family farm or fishing corporation.

segment, i.e., $500,000 for SMEs in the farming or fishing industries and $417,858 for all other segments.

Based on the types of transfers, the owners' additional taxable income that would result from the sale of their SME shares can thus be deducted on the assumption that they own 100% of the shares. Therefore, from this single database, we can present our weighted estimates of the total number of SMEs in all segments based on the types of transfers contemplated by the owners, with an estimate of the average total annual sales of these SMEs for Québec and the ROC Canada (excluding Québec) in Tables 5 and 6 below.

As can be seen in Table 5, a total of 33,867 SME owners in Québec reported in 2017 that they intended to transfer their SME within the five subsequent years. These SMEs generate approximately $67.3 billion in annual sales. Of this number, 10,414 favour a family transfer.

Table 5
Number and Average Sales of SMEs Based on Transfer Type for All Industries in Québec

2017 Data	Family Transfers			Other Types of Transfers			TOTAL
	Capital gain exceeded the exemption limit in 2017			Capital gain exceeded the exemption limit in 2017			
	No	Yes	Sub-Total	No	Yes	Sub-Total	
Number of SMEs (weighted)	7,580	2,834	10,414	19,379	4,074	23,453	33,867
	72.8%	27.2%	30.7%	82.6%	17.4%	69.3%	100%
Average sales (weighted)	$1,300,039	$7,720,282		$760,805	$5,120,857		
TOTAL ($ billion)	$9,854	$21,879	$31,733	$14,744	$20,862	$35,606	$67,339

From the 10,414 entrepreneurs, 7,580 are heads of SMEs that, according to our estimates, would have a market value generating taxable capital gains below the exemption limits, whereas only 2,834 generate taxable capital gains above the exemption limits.[11] Table 5 also reveals that the annual sales of SMEs that generate taxable capital gains are substantially higher than those of SMEs with taxable capital gains below the deduction limit – approximately $7.7 million and $1.3 million respectively on average for family transfers and $5.1 million and $761 thousand on average for other types of transfers. This suggests that Québec SME owners who favour a family transfer have a more advantageous balance sheet than the others, even though they are proportionally fewer in number (30.7%).

Table 6 shows that the proportion of SMEs to be transferred in the rest of Canada is almost identical to the situation in Québec. On the other hand, the number of SMEs that generate sales above the exemption limit is much lower in the other Canadian provinces when compared to Québec, with $3.3 million in sales compared to $7.7 million for Québec. Overall, the total annual sales of SMEs likely to be transferred are estimated at $141.9 billion in the other Canadian provinces.

[11] Restrictions on the risk of residual disclosure of confidentiality prevent us from presenting our estimates for the various segments that have different exemption limits.

Table 6
Number and Average Sales of SMEs Based on Transfer Intentions for All Industries in the Canadian Provinces Other Than Québec

2017 Data	Family Transfers			Other Types of Transfers			TOTAL
	Capital gain exceeded the exemption limit in 2017			Capital gain exceeded the exemption limit in 2017			
	No	Yes	Sub-total	No	Yes	Sub-total	
Number of SMEs (est.)	15,894	6,864	22,758	56,263	10,985	67,248	90,006
	69.8.%	30.2%	25.3%	83.7%	16.3%	74.7%	100%
Average sales (est.)	$1,294,077	$3,326,397	--	$885,894	$4,425,423	--	
TOTAL ($ billion)	$20,568	$22,832	$43,400	$49,843	$48,613	$98,456	$141,856

Lastly, transfers other than to family successors appear to be less favoured in the other Canadian provinces, regardless of the value of the taxable capital gains. The results of this analysis suggest that the additional income associated with family transfers is potentially greater in Québec than in the other Canadian provinces for two reasons. Firstly, because this type of transfer is contemplated in higher numbers in Québec than in the other Canadian provinces. And secondly, because the (weighted) average annual sales of SMEs for which a family transfer is favoured is higher in Québec; and, in particular for those whose taxable capital gains exceed the exemption limit for owners.

3. ANALYSIS AND RESULTS

In light of the theoretical calculations presented above, we understand that notwithstanding the market value of an SME, the tax rules are such that the additional taxable income resulting from the sale of shares of an SME varies substantially depending on the eligibility conditions for the capital gains deduction (CGD) and industry segment. The analysis of the theoretical calculations reveals that the extent of the inequities depends essentially on the fair market value of an SME, which determines the proceeds of disposition and, ultimately, the capital gain.

The analysis of the theoretical calculations reveals that the extent of the inequities depends essentially on the market value of an SME, which determines the proceeds of disposition and, ultimately, the capital gain.

First, in the case of qualified farm or fishing property (QFFP) that would be eligible for the CGD at the provincial level, eligibility for the CGD involves a significant reduction in additional income for the owner.[12] For an SME in this industry with proceeds of disposition of $100,000, the owners retain 100% of the proceeds of disposition received, whereas non-eligible owners retain between 73% and 94% of the proceeds of disposition received, depending on their taxable income.[13] For a $2 million SME (QFFP) whose capital gains exceed the $1 million capital

[12] The Department of Finance Canada and Agriculture and Agri-Food Canada are studying the development of tax measures that would facilitate family farm transfers so that small and medium-sized farm businesses can qualify for such a deduction (Canada, 2019a, 2019b; Canada, 2017).

[13] Since 50% of the capital gains is taxable at the inclusion rate and the marginal tax rate varied between 12.53% and 53.31% depending on the taxpayer's taxable income bracket in 2017, the additional income resulting from the capital gain for owners falls between 6.3% and 26.6% of the capital gains in this case.

gains exemption limit, owners retain at least $365,000 more of the proceeds of disposition received, while non-eligible owners must pay this additional amount on his or her income tax.[14]

Second, in addition to the eligibility requirements for the capital gains deduction, an SME's industry segment can amplify the additional income of the owners. For example, in the case of an SME owner (QSBCS) eligible for the CGD from an industry other than an SME with farming or fishing property with proceeds of disposition of $2 million, the owner had to include additional income as a result of the fact that the maximum capital gains deduction limit of $417,858 (column B, line 8) was lower than that of a small business with farming or fishing property of $500,000 in 2017. In this case, the difference in additional taxable income of $82,142 represents between $10,292 and $43,790 for the owner based on his or her marginal tax rate compared to SMEs with farm or fishing property, whereas the capital gains realized in both cases is exactly the same. In other words, the fact that a transfer to a family successor is ineligible for the CGD represents, for the SME owner, a source of horizontal inequity between SMEs with farm or fishing property and those in many other segments of the economies in Québec and the ROC.[15]

3.1 Estimates of the tax impact of SME transfer intentions in Québec

Table 7 presents our estimates of taxable capital gains and average additional taxable income from family transfers in Québec, making a distinction between the type of transfer and eligibility for the capital gains deduction for SMEs in all Québec industries. The estimates in this table give us a better idea of the tax impact of SME transfers on the economies in Québec and the ROC.

Firstly, we note that the Québec SME transfer market in 2017 alone represents a potential of approximately $15.7 billion in taxable capital gains over a five-year period, which is a little more than $3 billion in capital gains per year on average. Since the realization of capital gains contributes to the income of taxpayers in an economy, SME transfer intentions would annually generate the equivalent of 1.4% of the total remuneration for all employment in Québec in 2017.[16] This potential contribution to taxpayers' taxable income is significant for the overall Québec economy, as it is slightly lower than the total remuneration for employment in the real estate and rental and leasing industries and represented a little over 53% of the total remuneration for all employment in the information and cultural industries in 2017.[17]

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[14] For an SME (QFFP) with proceeds of disposition of $2 million, the $1 million capital gains deduction represents a reduction in additional taxable income of $500,000. Given the marginal tax rates (federal and provincial) in 2017, owners of non-eligible SMEs retained at least 73% of the capital gains realized at the top of the marginal tax rate in 2017.

[15] Charest (2019) indicates that the sectoral restrictions on QSBCSs were abandoned by the Ministère des Finances du Québec in 2017.

[16] Total remuneration for all employment in Québec in 2017 was slightly over $228 billion (Statistics Canada, Table 36-10-0489-01).

[17] The North American Industry Classification System (NAICS) code for the real estate and rental and leasing services industry is 53 and the information and cultural industries code is 51.

Secondly, when owners favour a transfer to an external successor, they can benefit from a maximum capital gains deduction of $417,858 or $500,000 depending on their industry segment. This deduction essentially corresponds to a tax incentive stemming from the legislator's goal of stimulating entrepreneurial dynamism. Given that they are eligible for the capital gains deduction, this tax deduction is estimated to be equivalent to a gain of $64,459 on average for 19,379 owners for whom the taxable capital gains would be below the applicable maximum deduction and $411,569 on average for the 4,074 others for whom the taxable capital gains would exceed the maximum deduction.

The tax relief represents a little over $2.9 billion for both levels of government over a five-year period (2017-2022), or approximately $580 million annually.

(The calculated tax relief is equal to 19,379 SMEs below the exemption limit × $64,459 in average taxable capital gains (weighted) for these SMEs + 4,074 SMEs above the exemption limit × $411,569 in average taxable capital gains (weighted) for these SMEs.)

Thirdly, even if a certain easing of the tax provisions that apply to family SME transfers have been introduced in Québec to allow their owners to be eligible for the capital gains deduction, the criteria used by the tax authorities are not flexible enough to address the realities of this type of transfer (Charest, 2019).

Thus, for the 7,580 and 2,834 owners who intend to transfer to a family successor, the entire taxable capital gains could be added to their taxable income. For the 7,580 for whom the capital gains were below the maximum deduction of $417,858 for SMEs (QSBCS) and $500,000 for SMEs with farm or fishing property (QFFP), the estimated average taxable capital gain was $91,567 in 2017.

The Québec SME transfer market in 2017 alone represented a potential of approximately $15.7 billion in taxable capital gains over a five-year period, or a little over $3 billion in capital gains per year on average.

For the 2,834 other SMEs for which the taxable capital gains would have been higher than the deduction associated with the exemption limits, the average taxable capital gain was slightly over $2 million in 2017. Since only the portion of the taxable capital gain that exceeds the maximum deduction is taxable, the maximum deduction based on SME industry segment was estimated at $446,836[18] in 2017. Therefore, for the 10,414 potential owners who favour a family transfer, our estimates suggest that the ineligibility for the capital gains deduction under section 110.6 of the federal ITA and section 726.7 of the QTA represents a little over $1.96 billion over a five-year period.[19]

[18] The amount of $446,836 corresponds to a combination of the deduction limits of $417,858 for SMEs (QSBCS) and $500,000 for SMEs with farm or fishing property (QFFP).

[19] The amount of $1.960 billion is derived from the weighted amount of $7,580 × $91,567/SME + $2,834 × $446,836/SME.

Table 7
Taxable Income Based on Transfer Intentions
(All Industries in Québec)

2017 Data	Family Transfers		Other Types of Transfers	
	Capital gain exceeded the exemption limit in 2017		Capital gain exceeded the exemption limit in 2017	
	No	Yes	No	Yes
Number (est.)	7,580	2,834	19,379	4,074
Average taxable capital gain (est.)	$91,567	$2,001,773	$64,459	$1,977,648
Average tax deduction (est.)	$0	$0	$64,459	$411,569
Average additional taxable income (est.)	$91,567	$2,001,773	$0	$1,566,079

This amount represents the (weighted) amount of additional taxable income for which tax relief would be granted if the tax deduction were easily available to these owners. Given that a taxpayer's marginal tax rate ranged from 12.53% to 53.31% in 2017, our results suggest that these owners could save from $245.6 million to a little over $1.04 billion if they were eligible for the same capital gains deduction as owners who favour transfers to an external successor.[20] In our opinion, this interval likely corresponds to the maximum value of the tax impact of the tax relief that applies to family transfers of Québec SMEs. Since these amounts are maximums that would be paid in addition to income tax, they also represent the tax impact for governments and the importance of legitimizing family SME transfers. Québec owners remain the main beneficiaries of the sustainability of their SMEs. For those who favour transfers to family successors, our estimates show that they would reap more than $5.3 billion if they were eligible for the same capital gains deduction as owners who favour external successors.

The privacy rules in effect at Statistics Canada prevent us from presenting our estimates of the average (weighted) taxable capital gain and the average (weighted) additional taxable income for the farming and fishing industry in Québec. However, it can be inferred from Table 7 that family transfers are more disadvantageous for owners in this industry given the proportionately higher market value of such SMEs.

Table 8 confirms that the transfer to a non-arm's length successor is proportionally more significant in the farming and fishing industry. The average taxable capital gain is lower ($417,858 vs. $446,836) when SMEs in the farming and fishing industry are excluded from the calculation. Our estimates confirm that when the taxable capital gain exceeds the maximum deduction, the maximum deduction for all industries, excluding the farming and fishing industry, is estimated to be exactly $417,858 in 2017.

[20] Since this is a lifetime exemption for capital gains realized on the disposition of eligible shares, these amounts are maximum contributions.

Table 8
Additional Taxable Income Based on Transfer Intentions
(All Industries Excluding Farming and Fishing in Québec)

2017 Data	Family Transfers		Other Types of Transfers	
	Capital gain exceeded the exemption limit in 2017		Capital gain exceeded the exemption limit in 2017	
	No	Yes	No	Yes
Number (est.)	Undisclosed	Undisclosed	19,022	3,890
Average taxable capital gain (est.)	$79,331	$1,920,535	$63,513	$1,990,834
Average tax deduction (est.)	$0	$0	$63,513	$417,858
Average additional taxable income (est.)	$79,331	$1,920,535	$0	$1,572,976

Note: “Undisclosed” means the estimate is not released in accordance with Statistic Canada confidentiality rules.

3.2 Estimates of the tax impact of SME transfer intentions in the other Canadian provinces

Table 9 presents our estimates of capital gains and average additional taxable income based on the type of transfer favoured by the potential SME owner for all industries in 2017 in the other Canadian provinces. As in Québec, SME transfers in the other Canadian provinces represent annual capital gains of just over $41 billion over a five-year period, or slightly over $8.2 billion per year. On a Canada-wide scale, the contribution of capital gains to the economy was equivalent to a contribution of slightly over $56.8 billion over a five-year period, or $11.4 billion annually, which corresponds to 1.0% of the total remuneration for all employment in Canada in 2017.

Our estimates show an average capital loss of $8,542 for 56,263 SME owners in the other Canadian provinces who wish to transfer to an external successor, whereas in Québec, those who choose this option can expect to realize capital gains of $64,459 (See Table 7).

However, the average capital gains of owners who prefer an external successor is lower than those who favour a family transfer. The 10,985 owners in the other Canadian provinces who wish to transfer their SME to an external successor can expect to realize average taxable capital gains of $2.6 million, or nearly 50% more than those who prefer a transfer to a family successor.

For the 15,894 owners in the other Canadian provinces who are considering a family successor and whose SME market value is insufficient to realize taxable capital gains above the allowable capital gains deduction, the transfer represents an average additional taxable income of $59,338. For the 6,864 others whose capital gains exceed the exemption limit, the average additional taxable income is $1.75 million per SME. The portion of the taxable capital gains that exceeds the maximum deduction is taxable, and the maximum deduction based on SME industry segment is estimated at $450,480[21] in 2017. Since these owners are not eligible for the exemption, the entire capital gains are taxable at the taxpayer's marginal tax rate. Thus, our estimates suggest that for all owners in the other Canadian provinces who favour a

[21] The amount of $450,480 corresponds to a combination of the deduction limits of $417,858 for SMEs (QSBCS) and $500,000 for SMEs with farm or fishing property (QFFP).

family transfer, the ineligibility for the capital gains deduction represents a base of slightly over $4 billion in additional taxable income over a five-year period.[22]

Table 9
Additional Taxable Income Based on Transfer Intentions
(All Industries in the Canadian Provinces Other Than Québec)

2017 Data	Family Transfers		Other Types of Transfers	
	Capital gain exceeded the exemption limit in 2017		Capital gain exceeded the exemption limit in 2017	
	No	Yes	No	Yes
Number (est.)	15,894	6,864	56,263	10,985
Average taxable capital gain (est.)	$59,338	$1,746,280	- $8,542	$2,613,819
Average tax deduction (est.)	$0	$0	- $8,542	$419,413
Average additional taxable income (est.)	$59,338	$1,746,280	$0	$2,194,406

Based on the marginal tax rates of Canadian taxpayers in effect in 2017, our results suggest that fair and neutral treatment of legitimate transfers to family successors could save the equivalent of $505.6 million to $2.2 billion for owners who favour this type of transfer.[23] This estimate in all likelihood represents the maximum tax impact of transfers to family successors for all SME owners in the other Canadian provinces.

[22] The estimate of $4 billion in additional taxable income is derived from the following calculation: $15,894 × $59,338/SME + $6,864 × $450,480/SME.
[23] Given that this is a lifetime exemption for capital gains realized on the disposition of eligible shares, these amounts represent maximum contributions.

4. DISCUSSION

The situation described in the previous section has two negative side effects that undermine the principle of tax neutrality for legitimate transfers of SMEs to family successors. The more modest SMEs for which the taxable capital gains fall below the exemption limit suffer the brunt of the fight against tax avoidance through planned surplus stripping by corporations that operate SMEs. For larger SMEs, for which the taxable capital gains are four to more than six times the exemption limit, the additional taxable income is relatively greater because of the exemption limit.

Our estimates show the importance public policy makers should assign to the realization of these SME transfer intentions, regardless of the type of transfer contemplated by the SME owner. In Québec alone, the total annual revenues of these SMEs in 2017 were estimated at approximately $67.4 billion and the capital gains that would be realized by all SME transfer activities could reach the $15.7 billion mark over a period of five years (2017-2022). For Canada as a whole, our estimates suggest that annual revenues and capital gains associated with SMEs that intend to transfer reached $209 billion in 2017 and could amount to $32.7 billion over the same five-year period.

Although our estimates reveal that the proportion of Québec SME owners who intend to transfer to a family successor represents only 30.7% of the total population wishing to transfer, these SMEs represent 47.1% of the total annual revenues and 40.6% of the capital gains, respectively. Our estimates of the total annual revenues of the 10,414 SMEs intended to be transferred to family successors added up to $31.7 billion in 2017, whereas they reach $67.3 billion annually for all 33,867 Québec SMEs whose owners intend to transfer over the next five years (2017-2022). In terms of capital gains, these same SMEs represent approximately $6.4 billion of the total $15.7 billion that would be generated by all types of SME transfers. These results confirm the impression expressed by certain researchers from other countries (Grundström et al., 2012; OSEO, 2007; PWC, 2018; Ryan and Power, 2012) that family transfers are to be reserved for the highest-performing SMEs. Given that in Québec, the tax treatment of this type of transfer represents additional taxes ranging from $245.6 million to $1.04 billion, depending on the marginal tax rate of these owners, tax inequities could represent up to 16.4% of the capital gains that will likely be realized by transfers to a family successor. This inequity is not insignificant.

Our results are more striking in the other Canadian provinces. Although the 22,758 SMEs that are intended to be transferred to a family successor represent only 25.3% of all owners who intend to transfer their firm within the next five years, they accounted for 30.6% of total revenues in 2017 and 75.8% of the capital gains that would likely be realized by all SME transfers. The tax inequities associated with family transfers in the other provinces are therefore potentially greater as these owners could save the equivalent of $505.6 million to $2.2 billion in additional taxes. The tax inequities represent up to 17% of the capital gains that would be realized through a family transfer in the other Canadian provinces.

Given that our findings concern the tax impact of transfer *intentions* reported in 2017, and not the number of transfers carried out, the unintended effects of a potentially significant additional tax burden for SME owners may discourage some from undertaking a transfer or encourage others to favour a transfer to an external successor. In the first case, our findings show that giving up on a family transfer project represents a relatively high opportunity cost for the economies in Québec and the ROC. In Québec, each SME transfer that would be abandoned could result in an economic loss of up to $91,567 for the least capitalized SMEs. Although the size and value of the assets of these SMEs are more modest in the other Canadian provinces, capitalization of the market value of an SME, regardless of size, is a positive contribution of the sustainability of an SME to the economy.

In the second case, where the additional tax burden encourages a Québec SME owner to favour an external successor, our estimates show that the owner can absorb a loss of up to $27,108 on average in the case of small-cap SMEs and up to $24,125 in cases where the capital gains exceed the exemption limit.[24] Although this type of substitution would be advantageous in the other Canadian provinces for larger-cap SMEs where the average taxable capital gain of SMEs from a transfer to a family successor is $867,539 higher. According to our estimates, SME owners and the economy absorb a loss in capital gains equivalent to $67,880 in the case of small-cap SMEs. Thus, the tax impact could exceed a simple tax transfer between SME owners and government coffers. We will address this issue in greater detail in a subsequent report.

Our analysis of the tax impact of SME transfers has certain limitations. Among other things, for methodological reasons, this analysis focuses on only two of the many factors that could guide the financial component of the type of transfer favoured by an SME owner: the *lifetime capital gains deduction limit*, which depends on the nature of the SME's property based on its industry segment and the *non-arm's length relationship* between the owner and the successor.

All of our estimates are based on the assumption that the adjusted cost base, i.e., the cost of a property plus the expenses incurred to acquire it (e.g., legal and professional fees), was nil. Obviously, for many owners, the initial cost of start-up is often greater than $1,000, particularly for successors who have acquired a profitable SME.

The available data from the Survey on Financing and Growth of Small and Medium Enterprises – 2017 prevents us from estimating the true adjusted cost base of an SME according to the owners' transfer intentions based on the age of the SME and the expenses to be incurred when the shares are sold. However, the average values of financing applications made by SMEs in this Survey suggest that the capital gains we have estimated could be overestimated by tens, if not hundreds of thousands of dollars. Our estimates are also based on the assumption that the SME transfer takes place within a single year. If an SME’s shares can be sold over several years, this could reduce the marginal tax rate of the owners and minimize the tax impact.

One of the important assumptions regarding the estimates presented above is that the SMEs have only one shareholder. When the capital gains are divided among several owners, each one is entitled to the same lifetime capital gains exemption, which reduces the taxable capital gains for the taxpayer. Once again, the data from this Survey prevent us from estimating the average capital gain per shareholder or obtaining the fair distribution of the capital gain in proportion to the distribution of the share capital held by all shareholders in accordance with CRA forms.

[24] It is assumed here that the difference can be attributed to the SME transfer mode. In the absence of any differences in transaction costs between a family and external transfer, the loss to the transferor is lower.

5. CONCLUSION AND RECOMMENDATIONS

For the last twenty years, business succession has been a subject of concern for public policy makers, professionals and researchers in Québec, the ROC and other developed countries (Corner and Ratté, 2017; Cossette and Mélançon, 2010; Duhamel et al., 2019; OECD, 2018; Shore Consulting, 2018). Out of concern for the vitality of the economic dynamism threatened by the aging of SME owner-managers, many are worried about the unintended and negative side effects of certain tax provisions that discourage the transfer of SMEs to one or more successors who have a non-arm's length family relationship with its owner(s).

The adverse impact of these tax rules on family transfers has long been the subject of studies, reports and even dissertations. However, exposing the main problem, i.e., violation of the *principle of tax neutrality* in legitimate family transfer cases, generally remains theoretical, conceptual and largely anecdotal. Even with the relaxations introduced by the Québec government since 2015 to the tax provisions that apply to family SME transfers, this perception of inequity regarding the tax rules remains, as those who wish to transfer their SME to family successors are, in light of our findings, still at a disadvantage compared to those who transfer to external successors. In addition, our estimates reveal a substantial economic potential associated with family transfers for Québec and the other Canadian provinces that exceeds manifold the losses anticipated as a result of the surplus stripping tax planning activities of private corporations.

In light of the results of this study, we hereby issue three main recommendations.

Recommendation 1: Many stakeholders would benefit from ***easing the eligibility conditions for the capital gains deduction*** for legitimate transfers, regardless of transfer type.

One of the main difficulties raised by Charest (2019) regarding the eligibility conditions for a transfer to a family successor is the need to have the owner's "disengagement" coincide with the transfer of shares over a maximum period of 24 months. However, this eligibility condition violates the best practices recommended by transfer experts, who consider that the longer the owner and the successor cohabitate, and the more flexible the conditions for selling the shares, the greater the chances of the transfer project becoming successful (Cadieux and Brouard, 2009; Cadieux et al. 2020; OSEO, 2007). From this perspective, other questions emerge regarding the consistency between the current conditions and the recognized practices within the professional and scientific communities regarding SME transfers. For example, why require the complete withdrawal of the owner after transferring the shares of the SME to a non-arm's length family successor? Would it not be preferable to have him or her serve as chairman of the board of directors for as long as he or she feels useful?

Another eligibility condition requires that a family successor must acquire all of the SME's shares personally, and not through a corporation, in order for the owner to benefit from the capital gains deduction (Charest, 2019). However, this option, which is financially more expensive for the successor, could reduce the price the owner can get for the shares of the SME, regardless of the type of transfer, if he or she sincerely wishes to ensure the sustainability of the SME. Owners who wish to transfer to a family successor may find themselves at a double disadvantage compared to those who wish to transfer to an external successor. Firstly, these conditions may prevent them from benefitting from the capital gains deduction. Secondly, they may have a negative effect on the SME's market value. It should also be noted that, according to the CTEQ Index, the "typical" Québec buyer is 40 years old and has an average down

payment of $360,000 (Cadieux et al., 2020). Such a buyer therefore has professional experience prior to the succession project that has allowed him or her to accumulate enough savings to take over an SME, but not enough to buy all of the owner's shares. It would therefore be interesting to consider implementing facilitating measures for the successor that would allow him or her to ensure the sustainability of a viable SME and, in the process, participate in Québec's economic dynamism.

To sum up, despite the fact that the eligibility conditions for the capital gains deduction have a legitimate goal of fighting tax avoidance, in the short term, they need to be eased so that the maximum number of owners can benefit from their rights. To make them more flexible, a thorough analysis must be carried out in collaboration with transfer experts, other than those usually called upon, so as to better represent the realities of SME owners and their successors.

Recommendation 2: Given the significance of the economic benefits of transferring to a non-arm's length family successor in all industry segments in the Canadian economy, it appears important to ***harmonize tax rules between the federal and provincial governments*** without unduly burdening the administrative treatment of the eligibility conditions. Harmonization efforts should focus on those segments that are the most threatened by the aging of SME owners or those that are most likely to generate spinoffs in terms of productivity growth and economic wealth.

The economies in Québec and the ROC have undergone a deep transformation over the last 30 years toward an economy based on services, knowledge, innovation, and new technologies incorporated into global value chains. In the short term, reforming the tax rules by harmonizing and indexing the lifetime capital gains exemption limits would promote greater horizontal equity among SME owners in various segments of the economy. The rules would also have to be simplified as part of this harmonization.

The lifetime capital gains exemption has been contested since it was introduced by Finance Minister Michael Wilson in 1985. Although it has been amended several times since then, significant criticism of this tax measure continues to this day (Couzin, 1995; Mintz and Richardson, 1995; Thompson, 1995; McKenzie and Thompson, 1995). Even before it was introduced, many have decried its administrative complexity and negative side effects, which run against the very goal of this tax measure, which is to encourage SME growth and start-ups as well as active risk-taking in the capitalization of small high-technology firms.[25]

Since 1987, the economies in Québec and the ROC have continued their transformation toward tertiary industries at the expense of the primary and secondary sectors.[26] While the farming and fishing industries represented 2.9% of Canada's nominal GDP in 1987, they respectively represented only 1.8% and 1.5% in Canada overall and Québec in particular in 2016. In addition to the strong growth of the oil and gas industry in Canada, the share of the professional, technical and scientific services industry increased from 2.7% to 5.9% in Canada overall between 1987 and 2016, and also represents 5.9% of GDP in Québec. A

[25] In particular, see Wilson, J. R. (1995). The Structural Impact of the Capital Gains Deduction on the Canadian Tax System. *Canadian Public Policy – Analyse de politiques*, Vol. 21 (Supplement), pp. 206-224. Wilson (1995, S207-S211) provides a revealing historical overview of this tax measure, which originated in the preferential treatment of capital gains in British tax law. More recently, see the 9th observation (pp. 15-16) in Godbout, L. (2017). *Regard sur une réforme annoncée: Observations dans le cadre des Consultations du ministère des Finances du Canada sur la planification fiscale au moyen de sociétés privées*. Regard, No. 2017-04. Chaire de recherche en fiscalité et finance publique. Université de Sherbrooke. October 2, 2017.

[26] In 1987, the primary, secondary, and tertiary sectors of the Canadian economy accounted for 8.0%, 27.4%, and 64.6% of gross domestic product (GDP), respectively. In 2016, these sectors represented 6.0%, 20.5% and 73.5% of the Canadian economy and 2.9%, 23.7% and 73.4% of the Québec economy, respectively. The calculations in this paragraph are based on CANSIM tables 379-0023 (1987) and 36-10-0487-01 (2016) from Statistics Canada.

neutral and fair tax treatment of intangible capital gains for SMEs in this industry appears to us as being just as consistent with the intended goal as it is for farming and fishing SMEs.

Lastly, in order to simplify SME transfers and establish neutrality based on industry segment, it would be appropriate to standardize the eligibility conditions as well as the amount of the lifetime capital gains exemption at $1,000,000 and the capital gains deduction at $500,000, both for the disposition of qualified small business corporation shares (QSBCS) and for qualified farm or fishing property (QFFP). This can be achieved by making technical changes to the tax rules, in particular to sections 84.1 and 55 of the *Income Tax Act* and similar rules in all Canadian provinces.

Recommendation 3: In the longer term, and we are fully aware of the deep debates that have been ongoing since the Carter Commission in Canada, and revisited more recently by the Godbout Commission in Québec, we believe it is essential to seize the opportunity provided by the COVID-19 pandemic recovery efforts to ***implement the tax reforms required*** to revive SMEs and facilitate family SME transfers.

In order to return to the initial purpose of the lifetime capital gains exemption, i.e. to break the chains of entrepreneurial dynamism both in Québec and the ROC, many are calling for an extensive reform of the tax treatment of SMEs that would go as far as to convert this measure into a taxable income deduction when the proceeds from the sale of shares of an SME are transferred to a registered retirement savings plan (RRSP).[27]

Although the reforms generally proposed aim to encourage SME start-ups and growth, there is a notable lack of tangible proposals for a neutral, fair, and effective treatment of family transfers from a perspective of intergenerational growth (Chen and Mintz, 2011; Mallet, 2015). This is a major omission in our view. In this regard, based on the principle that family transfers are important for their economies, some countries facilitate such transfers by simply not taxing them (Alpeza, Singer and Jurie, 2016; OECD, 2018; Ryan and Power, 2012).

The number of taxpayers who claim the lifetime capital gains exemption has hovered around the 60,000 mark since 2013 in Canada (Department of Finance, 2019). In Québec, 8,444 taxpayers benefited from the limited capital gains exemption on qualified shares of a corporation operating an SME in 2017 for a total value of $182.6 million for the Québec government (Ministère des Finances, 2020). Our annual estimates of the proportion of owners who intend to undertake a family transfer corresponds to approximately 10% of the number of taxpayers who claim this deduction annually in Canada overall and 25% in Québec in particular.

Given the size of the amounts involved, it appears essential that the federal government avoid neglecting the tax inequities, in the order of 16.4% of capital gains that can be realized during a transfer in Québec and 17% in the other Canadian provinces, associated with family SME transfers. Considering the magnitude of the tax expenditures that have been directed toward SME start-ups and growth in recent years, interest in the start-ups, gazelles and unicorns of entrepreneurship appears to have been to the detriment of family transfers, which could benefit from the positive effects of strategic renewal and contribute just as much to the growth, development and sustainability of our economic fabric.

[27] In particular, see Godbout (2017), supra note 30 on page 15.

Our recommendations reach beyond the objectives of this report. Some, as well as many others, have already been the subject of proposals as part of the Commission d'examen sur la fiscalité québécoise or at other times.[28] However, we believe that it would be appropriate for both levels of government to mobilize several of these proposals to foster the dynamism of Québec's entrepreneurial ecosystem and through tax measures that promote the sustainability of Québec SMEs now facing the dual threat of the accelerated aging of its owner-managers and the COVID-19 pandemic.

[28] For an overview of previous tax recommendations on the transfer of SMEs, see Brouard, Duhamel and Cadieux (2020).

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Appendix 1
Ratio of Market Value to Book Value, 2017

Ratio of Market Value to Book Value of Canadian Corporations, 2017

	Book Value	Market Value	Ratio MV/BV
Q4 2017	$3,111,505	$4,833,644	1.55
Q3 2017	$2,974,670	$4,520,725	1.52
Q2 2017	$3,042,101	$4,534,555	1.49
Q1 2017	$3,047,373	$4,510,877	1.48
Average 2017			1.51

Note: The book and market values correspond to “total assets.”
Source: Statistics Canada. Table 36-10-0485-01. International investment position, book and market values, quarterly (x 1,000,000)
DOI:https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610048501&request_locale=en

Ratio of Market Value to Book Value of Canadian Corporations, 2007-2018

Year	MV/BV Annual Average
2007	1.65
2008	1.40
2009	1.28
2010	1.35
2011	1.32
2012	1.32
2013	1.40
2014	1.47
2015	1.43
2016	1.41
2017	1.51
2018	1.50

Note: The book and market values correspond to the “total assets.”
Source: Authors’ calculations based on Statistics Canada. Table 36-10-0485-01. International investment position, book and market values, quarterly (x 1,000,000)
DOI:https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610048501&request_locale=en

Appendix 2
Marginal Tax Rates, 2017

The combined marginal tax rates (federal and provincial – Québec) for 2017 are presented here. These rates are similar within 2017. They are rounded off to provide an order of magnitude in the calculations only. These are the marginal tax rates, i.e. the rates that would apply to additional income, and not the average tax rates. For the purposes of analysis, two marginal tax rates are used: 37% and 53%. The 37% rate is used for the bottom level of proceeds of disposition, while the 53% rate is used for the top level of proceeds of disposition. These rates assume the presence of other sources of income (e.g., employment income or dividends) in addition to the additional income from the disposal of the SME.

Marginal Tax Rates (Federal and Provincial – Québec) - 2017 Tax Year

	Additional Taxable Income						
	12,000	50,000	60,000	70,000	100,000	200,000	>202800
Marginal rage	12.53%	37.12%	37.12%	37.12%	45.71%	49.97%	53.31%
Rounded rate	12%	37%	37%	37%	45%	50%	53%

Source: *Income Tax Act of Canada* - Wolters Kluwer (2018)