
Employee Ownership Trusts

An Employee Ownership Trust (“EOT”) is a form of employee ownership where a trust holds shares of a corporation for the benefit of the corporation’s employees. EOTs can be used to facilitate the purchase of a business by its employees, without requiring them to pay directly to acquire shares. For business owners, an EOT can also provide an additional option for succession planning.

Recent Federal budgets outlined the government’s intention to engage with stakeholders through a consultation process to address barriers that existed in the tax legislation, which lacked a dedicated trust vehicle tailored to facilitate employee ownership and/or the transition of a privately owned business to its employees. Subsequently, proposals to introduce Employee Ownership Trusts were presented in the 2023 Federal Budget and amended draft legislation was tabled in November 2023. Once enacted, this new legislation, is scheduled to apply as of January 1, 2024, is intended to facilitate the creation of EOTs to acquire and hold shares of a business, by defining the qualifying conditions to be an EOT, amending existing tax rules to accommodate EOTs, and providing new tax incentives to encourage their usage.

In general, the EOT concept is based on the expectation for the vendor or the underlying business being sold to provide the necessary funding to the EOT for the purchase, on behalf of the employees. Thereafter, this loan would be repaid over the long-term, out of the future profits of the business.

Qualifying Conditions

The following general rules and definitions would apply to EOTs:

Overview

A trust would be considered an EOT if it is a Canadian resident trust that holds shares of a qualifying business(es) for the benefit of the employee beneficiaries of the trust. It would make distributions to qualifying employee beneficiaries, where reasonable, under a distribution formula that could only consider an employee’s length of service, remuneration, and hours worked.

An EOT would be required to hold a controlling interest in the shares of one or more qualifying businesses and all or substantially all of an EOT’s assets must be shares of qualifying businesses.

Qualifying business – A qualifying business would need to meet certain conditions, including that it is controlled by the trust and is a Canadian-Controlled Private Corporation. Following the sale of a qualifying business to an EOT, the qualifying business must deal at arm’s length with the individuals who held a significant economic interest in the business prior to the sale, and these individuals (and their related persons) would not be able to account for more than 40% of directors of any qualifying business of the EOT.

Qualifying employee beneficiaries – Beneficiaries of the trust must consist exclusively of qualifying employees. Qualifying employees would include all individuals employed by a qualifying business and any other qualifying businesses it controls, with the exclusion of employees who are significant economic interest holders or have not completed a reasonable probationary period of up to 12 months. Former employees who were employed by a qualifying business while it was controlled by the EOT are also eligible.

However, individuals (and related persons) who hold, or held prior to the sale to an EOT, a significant economic interest in a qualifying business of the EOT are excluded from being qualifying employees.

Qualifying Business Transfer

A qualifying business transfer would occur when a taxpayer disposes of shares of a “subject corporation” to the EOT. Immediately before the disposition, all or substantially all of the fair market value of the assets of the subject corporation must be attributable to assets that are used primarily in an active business. The shares can be disposed to either a trust that qualifies as an EOT immediately after the sale, or a corporation wholly owned and controlled by the EOT. The EOT must own a controlling interest in the qualifying business immediately after the qualifying business transfer, and at all times after the disposition the taxpayer must deal at arm’s length with the subject corporation, the trust (and any purchaser corporation). In addition, at all times after the disposition the taxpayer must not retain any right or influence that, if exercised, would allow the taxpayer (whether alone or together with any related persons) to control, directly or indirectly in any manner whatever, the subject corporation, the trust, or any purchaser corporation.

Governance and Trustee Representation

Various conditions are provided for the governance of the EOT, including the composition of the trustees of the EOT, to balance the interests of the selling shareholders of a qualifying business with the interests of the purchasing employees. For example, at least one-third of the trustees must be beneficiaries of the EOT as current employees of a qualifying business controlled by the trust. In general, at least 60% of all trustees must be persons that deal at arm’s length with any person who sold shares of a qualifying business to the EOT. In addition, current employee beneficiaries of the EOT must approve certain fundamental changes to the qualifying business(es) controlled by the trust, which could materially impact their employment and/or beneficial interest in the business(es).

Tax Treatment

The EOT would be a taxable trust and would; therefore generally be subject to the same rules as other personal trusts. Undistributed trust income would be taxed in the EOT at the top personal marginal tax rate, whereas trust income distributed from an EOT to its beneficiaries would not be subject to tax at the trust level, but at the beneficiary level.

Facilitating the Establishment of EOTs

To better accommodate the establishment and use of EOTs, certain existing tax rules would be modified, as follows:

Capital Gains Exemption

A capital gain is triggered when shares of a qualifying business are transferred to an EOT. The Fall 2023 Economic Statement proposed that new legislation will exempt the first \$10 million in capital gains realized on this transfer, subject to certain conditions. This incentive is proposed to be in effect for the 2024, 2025, and 2026 taxation years. However, legislation concerning this exemption and related details has not yet been released.

Ten-Year Capital Gains Reserve

Since it is anticipated that sales to an EOT could have an extended period of deferred consideration, new legislation extends the existing five-year capital gains reserve to a ten-year reserve for qualifying business transfers to an EOT. A minimum of 10 per cent of the gain would be required to be brought into income each year, creating a maximum ten-year deferral period. All individuals who disposed of shares in a qualifying business transfer would be eligible to claim this expanded capital gains reserve.

Exception to Shareholder Loan Rules

Taxpayers who receive a shareholder loan are generally required to include the loaned amount in income in the year the loan is received unless the loan is repaid within a year. Under the new legislation for EOTs, there is an exception to these shareholder loan rules to extend the repayment period from one to fifteen years for amounts loaned to the EOT from a qualifying business to purchase shares in a qualifying business transfer.

In addition, an exception is provided (for up to fifteen years) to the deemed interest benefit that would otherwise be imputed on a low (or no) interest-bearing loan where an EOT borrows funds from a qualifying business to fund its purchase.

Exception to 21-year rule

To prevent the indefinite deferral of tax on accrued capital gains, certain trusts are deemed to dispose of their capital property at 21-year intervals. Since an EOT is intended to allow for shares to be held indefinitely for the benefit of employees, qualifying EOTs will be exempt from the 21-year rule.

Conclusion

These new EOT rules are a positive development for business owners looking for an additional exit option and those motivated to transition their business to employees in a tax-efficient manner.

However, these rules are highly prescriptive and require the owner to divest of a controlling interest in their business, with a payout of the sales proceeds over the long term. The inability of a departing owner to maintain (or re-acquire) control of their business may entail additional risks which could necessitate their ongoing involvement in the business (to the extent permitted) to ensure its continued success. However, with the recent introduction of a \$10 million exemption for capital gains, it is expected that more business owners will consider an EOT as a viable option for transition.

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