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Tax Alert – Canada

Finance releases draft legislation to facilitate the use of employee ownership trusts

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 30 November 2023, Bill C-59, *Fall Economic Statement Implementation Act, 2023*, received first reading in the House of Commons. The bill contains, among other things, certain measures announced in the *Fall Economic Statement 2023* (FES) and certain provisions of the 2023 federal budget, including draft legislative proposals relating to the use of an employee ownership trust (EOT) to purchase and hold shares of a business.[1]

Broadly speaking, the draft legislative proposals (i) define the conditions for a trust to qualify as an EOT; (ii) extend the capital gains reserve from five to 10 years for qualifying sales to an EOT; (iii) create an exception to the current shareholder loan and deemed interest benefit rules; and (iv) exempt EOTs from the 21-year deemed disposition rule that applies to certain trusts. These amendments will apply as of 1 January 2024.

To encourage business owners to sell to an EOT, the FES proposed to exempt the first $10 million in capital gains realized on the sale of a business to an EOT from taxation, subject to certain conditions that were not included in the FES. Bill C-59 does not contain details with respect to this $10 million capital gains exemption.

In this Tax Alert, we provide a brief overview of the draft legislative proposals included in Bill C-59.

[1] For more information on the measures included in Bill C-59, see EY Tax Alert 2023 Issue No. 44. For more information on the measures included in the FES, see EY Tax Alert 2023 Issue No. 42.

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Background

An EOT is a form of employee ownership where a trust holds shares of a corporation for the benefit of the corporation's employees. A key appeal of an EOT is that it can be used to facilitate the purchase of a business by its employees without employees having to pay directly to acquire the shares. This presents an additional option for succession planning by private business owners, whose options have traditionally been limited to transitioning the business to family members or selling the business to management or a third party.

Typically, the underlying business will loan funds to the EOT, which then uses the funds to acquire a controlling interest in the business. The business is held in the EOT for the benefit of employees, and the loan is repaid out of earnings generated by the business. The US and UK both have structures to encourage ownership by employees, but the EOT structure proposed is more similar to the UK model.

Qualifying conditions

An EOT is a Canadian-resident trust (excluding deemed resident trusts) that has only two purposes: (i) to hold shares of a qualifying business for the benefit of the employee and former employee beneficiaries, and (ii) to make distributions to beneficiaries under a distribution formula that only considers an employee or former employee's length of service, remuneration, hours worked or a combination of the foregoing factors. Since the intention is that distributions not be unduly skewed towards high-income earners, remuneration for these purposes is capped at twice the highest marginal income tax bracket. Other criteria must not be considered in determining the beneficiaries' income and capital interests in the EOT. All or substantially all of the fair market value of the EOT's property must be shares of one or more qualifying businesses. A qualifying business is a Canadian-controlled private corporation (CCPC) that meets certain governance and board representation requirements.

A qualifying business transfer occurs when a taxpayer disposes of shares of a qualifying business to either an EOT or a CCPC that is wholly owned by an EOT, provided certain conditions are met. The EOT must own a controlling interest in the qualifying business directly, or indirectly through a CCPC that holds the qualifying business, immediately after the qualifying business transfer. In particular, following the transfer of the business to the EOT, not more than 40% of the directors of the qualifying business can comprise individuals who directly or indirectly, together with affiliated persons or partnerships, held 50% or more of the fair market value of shares or indebtedness of the business. In other words, following the transfer of the business to the EOT, the previous majority owners can no longer retain the right to control or influence the business.

Employee beneficiaries

Beneficiaries of the EOT must consist exclusively of individuals employed by a qualifying business controlled by the trust and individuals who were formerly employed by a qualifying business while the business was controlled by the EOT. The EOT may exclude employees who have not yet completed a probationary period of up to 12 months of employment. Individuals who are significant economic interest holders are also excluded as beneficiaries.

More than 50% of the beneficiaries of the EOT who are current employees of a qualifying business controlled by the trust must provide advance approval for both of the following: (i) any transaction or event (or series of transactions of events) that causes at least 25% of the beneficiaries to lose their status as beneficiaries (unless the change in status is in respect of a termination of employment for cause), and (ii) a winding-up, amalgamation or merger of a qualifying business (other than in the course of a transaction or event, or a series of transactions or events, that involves only persons or partnerships that are affiliated with the qualifying business).

Eligible trustees

Each trustee of the EOT must be either an individual (other than a trust) or a corporation resident in Canada that is licensed or otherwise authorized under the laws of Canada or a province to carry on the business of offering trustee services to the public. At least one third of the trustees must be beneficiaries of the EOT who are current employees of a qualifying business controlled by the trust. It appears that shareholders of a qualifying business could be trustees of the EOT; however, if any trustee is appointed rather than elected by the current employee beneficiaries, at least 60% of all trustees must deal at arm's length with each person who sold shares of a qualifying business to the EOT.

Additional governance and trustee representation conditions apply and are intended to balance the interests of the selling shareholders of a qualifying business with the interests of the purchasing employees.

Measures to facilitate the establishment of EOTs

The draft legislative proposals include the following measures to facilitate the use of EOTs:

Ten-year capital gains reserve

EOT arrangements are premised on the idea that the shares acquired by the EOT are paid for over time from earnings generated by the business. Recognizing that it can take time for the business to generate sufficient earnings to enable the EOT to pay the purchase price, the draft legislative proposals amend the *Income Tax Act* (the Act) to extend the capital gains reserve from five years to a maximum of 10 years in the case of a qualifying business transfer to an EOT or to a CCPC that is wholly owned by an EOT, pursuant to a qualifying business transfer.

All individuals who dispose of shares in a qualifying business transfer will be eligible to claim the expanded capital gains reserve.

Exception to shareholder loan and deemed interest benefit rules

Taxpayers who receive a shareholder loan are generally required to pay income tax on the loaned amount unless the loan is repaid within one year. Recognizing that an EOT will likely need more time to repay borrowed amounts, the draft legislative proposals introduce a new exception to extend the shareholder loan repayment period from one to 15 years for amounts loaned to the EOT from a qualifying business to purchase shares in a qualifying business transfer.

The draft legislative proposals also include a 15-year exception to the deemed interest benefit rule where an EOT borrows funds from a qualifying business for the purpose of purchasing the qualifying business pursuant to a qualifying business transfer.

Exception to 21-year deemed disposition rule

Certain trusts are deemed to dispose of their capital property at 21-year intervals. Recognizing that EOTs are intended to allow for shares to be held indefinitely for the benefit of employees, the draft legislative proposals exempt EOTs from the 21-year deemed disposition rule.

Temporary capital gains exemption (currently only included as a proposal in the FES)

Although draft legislation to implement this proposal is not included in Bill C-59, the FES proposed to exempt the first $10 million in capital gains realized on the sale of a business to an EOT from taxation, subject to certain conditions that were not provided in the FES. This incentive would be in effect for the 2024, 2025 and 2026 taxation years. The FES states that further details on this measure will be provided in the coming months.

Taxation of EOTs

An EOT is generally taxed in the same manner as other personal trusts. Undistributed trust income will be taxed in the EOT at the top personal marginal tax rate, whereas trust income distributed from the EOT to its beneficiaries will be subject to tax at the beneficiary level rather than at the trust level.

If the EOT distributes dividends received from a qualifying business, those dividends will retain their character when received by employee beneficiaries and their eligibility for the dividend tax credit.

An EOT is not considered an employee benefit plan or an employee trust for the purposes of the Act.

Key takeaways

The EOT rules in Bill C-59 are substantially similar to the draft legislative proposals released on 4 August 2023, but contain some notable changes to the draft amendments to the Act that were introduced with the 2023 budget. For example, the draft legislation no longer prohibits an EOT from distributing shares of a qualifying business to any beneficiary. This change gives the trustees more options if they are to dispose of a qualifying business or wind up the trust. In addition, the definition of *qualifying business* has been modified to remove the requirement that all or substantially all of the fair market value of the corporation's assets is attributable to assets used in an active business carried on primarily in Canada. This change increases the flexibility of businesses held by an EOT to expand operations outside Canada.

While it remains to be seen how appealing this new succession planning option will be for private business owners compared to selling the business to management or a third party, partly because the selling business owner will likely not be able to receive the full proceeds up front and there may be a risk that the full proceeds may not be received, the prospect of a $10 million capital gains exemption is expected to alleviate some of these concerns and will likely significantly increase uptake, particularly for smaller-sized transactions.

In general, we would expect these arrangements to be most appropriate for profitable companies with a sufficiently stable cash flow to enable the EOT to repay the loan out of earnings generated by the business.

In weighing their options, private business owners will have to consider the following before setting up an EOT:

- Loss of control of the business following the transfer to an EOT;
- The ongoing governance and compliance requirements that come with the EOT;
- The opportunity cost associated with a payout of the purchase price over several years;
- The risk of non-payment of the full purchase price; and
- The availability of loans from third-party lenders for this type of arrangement.

In addition, if the proposal from the FES to exempt the first $10 million in capital gains realized on the sale of a qualifying business to an EOT from taxation is enacted, private business owners will have an additional significant incentive to sell to an EOT in the years this incentive is in effect. While details pertaining to the $10 million capital gains exemption have not yet been released, a capital gains exemption of this magnitude is necessary to encourage widespread uptake of these arrangements. Because employee share ownership has the potential to play a part in addressing many of the current economic concerns, it is expected that the capital gains exemption will garner support across the political spectrum. We hope that the Department of Finance will move swiftly to introduce legislation concerning the $10 million capital gains exemption so that business owners looking to implement the EOT structure have less risk and face fewer unknowns.

Learn more

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