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 exit or succession planning.

Previous Federal budgets outlined the government's intention 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 have now been formally enacted in the tax legislation, with an effective date of January 1, 2024. This new legislation facilitates the creation of EOTs to acquire and hold shares of a business, by defining the qualifying conditions to be an EOT, amends existing tax rules to accommodate EOTs, and provides new tax incentives to encourage their usage. Additional incentives were introduced in the 2024 Federal Budget to provide a $10M temporary capital gains exemption on a sale to an EOT. These provisions were also enacted in June 2024 (with an effective date of January 1, 2024), however, at the time of writing, subsequent amendments to the EOT legislation are pending, to address some inconsistencies and integrate the EOT rules into the broader changes affecting the taxation of capital gains.[1]

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.

[1] The 2024 Federal Budget also expanded qualifying business transfers (along with related amendments to the Income Tax Act that facilitates transfers to EOTs) to include the sale of shares to a worker cooperative corporation as defined under the Canada Cooperatives Act, for qualifying dispositions of shares that occur between January 1, 2024, and December 31, 2026.

Qualifying Conditions

The following general rules and definitions 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. Furthermore, all or substantially all of the fair market value of the property of the Trust must be attributable to shares of the capital stock of one or more qualifying businesses that the Trust controls.

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 persons or partnerships who held >50% of FMV of shares/debt in the business prior to the sale, and they (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
The Trust must be for the exclusive benefit of all individuals who are 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 own a significant economic interest in the business 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. At the time of the disposition of the shares of the subject corporation, the vendor must deal at arm's length with the EOT (and any purchaser corporation), and the Trust must acquire control of the subject corporation. At all times after the disposition, the vendor must deal at arm's length with the subject corporation, the Trust (and any purchaser corporation) and must not retain any right or influence that, if exercised, would allow the vendor (whether alone or together with any related person or partnership) 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 appointed must be persons that deal at arm's length with any person who sold shares of a qualifying business to the EOT. In addition, the majority of 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 tax rules have been modified, as follows:

Capital Gains Exemption

A capital gain is triggered when shares of a qualifying business are transferred to an EOT. The 2024 Federal Budget introduced a new incentive which will exempt the first $10 million in capital gains realized on this transfer, for the 2024, 2025, and 2026 taxation years. Further details on the $10M exemption and its conditions, are as follows:

Qualifying Conditions

The exemption would be available to an individual (at least 18 years of age) on the sale of shares to an EOT, where the following conditions are met:

- The disposition of the subject corporation (that is not a professional corporation) occurs in the 2024, 2025 or 2026 taxation year by an individual (other than a Trust) under a *qualifying business transfer* to an EOT (or corporation wholly-owned by an EOT).
- The deduction has not been previously sought in respect of the same business.
- The Trust acquiring the shares is not already an EOT or a similar Trust with employee beneficiaries.
- Throughout the 24 months immediately prior to the qualifying business transfer:
    - the transferred shares were exclusively owned by the individual claiming the exemption, a related person, or a partnership in which the individual is a member; and
    - over 50% of the fair market value of the corporation's assets were used principally in an active business.
- At any time prior to the qualifying business transfer, the individual (or their spouse or common-law partner) has been actively engaged in the qualifying business on a regular and continuous basis for a minimum period of 24 months.
- Immediately after the qualifying business transfer, at least 75% of the beneficiaries of the EOT must be resident in Canada.

Joint Election

If the above conditions are satisfied, an individual would be eligible to claim an exemption for up to $10M in capital gains from the sale, pursuant to an election filed jointly with the EOT. If multiple individuals dispose of shares to an EOT and meet the above conditions, they may each

claim the exemption, but the total exemption in respect of the qualifying business transfer cannot exceed $10M. The individuals would be required to agree on how to allocate the exemption.

Disqualifying Events

A disqualifying event would occur if an EOT loses its status as an EOT or if less than 50% of the fair market value of the qualifying business' shares is attributable to assets used principally in an active business, at the beginning of two consecutive taxation years of the corporation.

If a disqualifying event occurs within 24 months of the qualifying business transfer, the exemption is deemed to have never applied, such that if the individual has already claimed the exemption, it would be retroactively denied.

If the disqualifying event occurs more than 24 months after a qualifying business transfer, the EOT would be deemed to realize a capital gain equal to the total amount of the (exempt) capital gains elected by the individual vendor(s) on the sale to the EOT.

Similar anti-avoidance rules as those that exist for the Lifetime Capital Gains Exemption (LCGE) could also apply to deny the $10M exemption.

Interaction with Alternative Minimum Tax (AMT)

Although the 2024 Federal Budget originally proposed that the capital gain exempted on a qualifying business transfer to an EOT would be subject to an inclusion rate of 30% for AMT purposes (similar to the AMT treatment for capital gains eligible for the LCGE), subsequent legislation enacted provides a 0% inclusion rate to exclude this exemption for AMT purposes. The EOT itself is also exempt from AMT.

Ten–Year Capital Gains Reserve

Since it is anticipated that sales to an EOT could have an extended period of deferred consideration, the new legislation extends the default 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 complex) 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.

For more information, please speak with your BMO Private Wealth professional.

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