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 provides an additional option for succession planning.

Budget 2023 proposes new rules to facilitate the use of EOTs to acquire and hold shares of a business. The new rules would define qualifying conditions to be an EOT and propose changes to tax rules to facilitate the establishment of EOTs.

These changes would extend the capital gains reserve to ten years for qualifying sales to an EOT, create an exception to the current shareholder loan rule, and exempt EOTs from the 21-year deemed disposition rule that applies to certain trusts.

Qualifying Conditions

The following subsections describe the qualifying conditions and general rules that would apply to EOTs. Additional restrictions may be included, as necessary, to protect the integrity of the tax system.

Definitions

A trust would be considered an EOT if it is a Canadian resident trust (excluding deemed resident trusts) and has only two purposes. First, it would hold shares of qualifying businesses for the benefit of the employee beneficiaries of the trust. Second, it would make distributions to employee beneficiaries, where reasonable, under a distribution formula that could only consider an employee's length of service, remuneration, and hours worked. Otherwise, all beneficiaries must generally be treated in a similar manner.

An EOT would be required to hold a controlling interest in the shares of one or more qualifying businesses. All or substantially all of an EOT's assets must be shares of qualifying businesses. A qualifying business would need to meet certain conditions, including that all or substantially all of the fair market value of its assets are attributable to assets used in an active business carried on in Canada. An EOT would not be permitted to allocate shares of qualifying businesses to individual beneficiaries. A qualifying business must not carry on its business as a partner to a partnership.

Governance

The trustees, including corporations that serve as trustees, would be required to be Canadian residents (excluding deemed residents). Trust beneficiaries (ages 18 and older) would elect the trustees at least once every five years. When an existing business is sold to an EOT, individuals and their related persons who held a significant economic interest in the existing business prior to the sale would not be able to account for more than 40 per cent of:

- the trustees of the EOT;
- directors of the board of a corporation serving as a trustee of the EOT; or
- directors of any qualifying business of the EOT.

Trust 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.

Individuals and their related persons who hold, or held prior to the sale to an EOT, a significant economic interest in a qualifying business of the EOT would also be excluded from being qualifying employees.

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. If the EOT distributes dividends received from qualifying businesses, those dividends would retain their character when received by employee beneficiaries and would therefore be eligible for the dividend tax credit.

Qualifying Business Transfer

A qualifying business transfer would occur when a taxpayer disposes of shares of a qualifying business for no more than fair market value. The shares must be disposed of to either a trust that qualifies as an EOT immediately after the sale or a corporation wholly-owned by the EOT. The EOT must own a controlling interest in the qualifying business immediately after the qualifying business transfer.

Facilitating the Establishment of EOTs

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

Ten-Year Capital Gains Reserve

When taxpayers receive proceeds of a sale of capital property on a deferred basis, they are permitted to defer recognition of the capital gain until the year in which they receive proceeds. A minimum of 20 per cent of the gain must be brought into income each year, creating a maximum five-year deferral period. It is anticipated that sales to an EOT could have an extended period of deferred consideration.

Budget 2023 proposes to extend the five-year capital gains reserve to a ten-year reserve for qualifying business transfers to an EOT. A minimum of ten 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 the proposed 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. If an EOT were to borrow from a qualifying business to finance the purchase of shares in a qualifying business transfer, the EOT would be required to repay borrowed amounts within one year of the qualifying business' taxation year end to avoid paying taxes on the loaned amount.

Budget 2023 proposes to introduce a new exception to extend the 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.

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. An EOT is intended to allow for shares to be held indefinitely for the benefit of employees. Consequently, the 21-year rule could create a significant tax liability for the EOT.

Budget 2023 proposes to exempt EOTs from the 21-year rule. If a trust no longer meets the conditions to be considered an EOT, the 21-year rule would be reinstated until the trust next meets the EOT conditions.

Coming into Force

These amendments would apply as of January 1, 2024.

Source: [Tax Measures : Supplementary Information | Budget 2023 (canada.ca)]