

# BUDGET 2023: EMPLOYEE OWNERSHIP TRUST MEASURES UNVEILED

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Consistent with the Federal Government's (the "**Government**") prior statements in Budget 2022, Budget 2023 proposes amendments to the *Income Tax Act* (Canada) (the "**Tax Act**") that will, according to the Government, facilitate the use of "Employee Ownership Trusts" or "EOTs" to acquire and hold shares of Canadian businesses and thereby enable participating employees to "share in the success of their work" and provide them with an opportunity to "receive their share of profits".

An Employee Ownership Trust is commonly understood to refer to a trust that holds shares of a corporation for the benefit of the corporation's employees. Such vehicles have been utilized with some measure of success in other G7 countries in recent years, most notably in the United States and Britain, for purposes of allowing the employees of a corporation to acquire shares of the corporation without being required to pay for the shares directly with out-of-pocket funds. For business owners, an EOT can potentially provide an additional option for succession planning.

Under the EOT measures contained in Budget 2023, a trust would be considered an EOT if it is a Canadian resident (excluding deemed resident trusts) and has only the following two purposes:

- a. holding shares of "qualifying businesses" for the benefit of eligible employee beneficiaries of the trust; and
- b. making distributions to employee beneficiaries, where reasonable, under a distribution formula that only considers an employee's length of service, remuneration, and hours worked (with employee beneficiaries otherwise being treated in a similar manner).

In addition, an eligible EOT would be required to hold (and limited to holding) a "controlling interest" in the shares of one or more "qualifying businesses", with all or substantially all of the EOT's assets comprising such shares. A "qualifying business" for this purpose would be a "Canadian-controlled private corporation" meeting 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 by the corporation (or certain of its subsidiaries) in Canada (other than through a partnership).

With respect to governance matters, the trustees of an eligible EOT would be required to be Canadian residents (excluding deemed residents) and stand for election at least once every five years. Additional rules aimed at ensuring independence from any prior ownership group would apply, including individuals previously holding a significant economic interest in the subject business prior to the sale not being able to account for more than 40 per cent of (i) the trustees of the EOT, (ii) the directors of the board of a corporation serving as a trustee of the EOT, or (iii) directors of any qualifying business of the EOT.

Eligible beneficiaries of an EOT would consist exclusively of “qualifying employees”, meaning all individuals employed by the applicable qualifying business or any qualifying businesses it controls, with the exception of employees who are present or former “significant economic interest holders”, or who have not completed a “reasonable probationary period” of up to 12 months.

Distributions to EOT beneficiaries would be permitted, provided that such distributions do not include shares of qualifying businesses and are determined with regard only to any combination of length of service, remuneration, and hours of service of the EOT beneficiaries.

The primary contemplated tax benefits under the EOT measures contained in Budget 2023 may be summarized as follows:

- a. an increased capital gains tax deferral in connection with the transfer of a qualifying business to an EOT (i.e., a capital gains reserve of up to 10 years, compared with the current maximum reserve of 5 years);
- b. an ability on the part of the qualifying business to loan funds to the EOT with a repayment period of up to fifteen years without triggering an income inclusion under the shareholder loan rules in section 15 of the Tax Act (Section 15 of the Tax Act generally requires a repayment of shareholder loans within one year);  
and
- c. an exemption from the so-called “21-year rule” applicable to most personal trusts, thus avoiding, among other things, a deemed disposition of the EOT’s assets on each 21-year anniversary of the EOT.

Aside from the benefits noted in (b) and (c) above, an EOT under the Tax Act would generally be taxable as an *inter vivos* trust (that is, taxable on its income at the top marginal tax rate) and subject to the same rules as other personal trusts under the Tax Act - including the permitted deduction with respect to income distributed to trust beneficiaries.

The new EOT measures are expected to come into effect as of January 1, 2024. A stakeholder consultation period will run through the end of May 2023 with an indicated focus on “how best to enhance employee rights and participation in the governance of Employee Ownership Trusts”.

Interestingly, the Government’s projections with respect to the anticipated fiscal impact of the EOT measures is

a revenue loss of just \$20 million over five years, possibly suggesting an expectation on the Government's part that the take-up on the new measures may be relatively modest. The Government's expectations could, in part, be based on the fact that the incentives to selling business owners are limited, as indicated above, to an increased potential capital gains reserve (unlike the *capital gains exemption* that is available under the British rules) and, as such, may not be viewed by business owners as sufficiently enticing after considering the relatively stringent governance and beneficiary eligibility requirements for EOT qualification, along with what may be viewed as a greater credit and liquidity risk compared to other owner exit strategies that may be available, such as, a sale to a competitor or private equity investor.

by [Todd Miller](#)

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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