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Employee Ownership Trusts – An Uncharted Option for Sale of Business in Canada

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Introduction

There may be an insurance opportunity or funding option in relation to a new sale of business option for private companies. This article walks through the legislative background, current rules and status of them as well as provides our thoughts on how insurance may integrate with them.

Legislative background

The 2023 Federal Budget introduced the concept of the purchase of a "qualifying business" by an Employee Ownership Trust (EOT) or a Canadian controlled private corporation (CCPC) controlled and wholly owned by an EOT as an additional succession planning option for business owners. The original draft legislation accompanying the Budget was followed by revised draft legislation on August 4, 2023, and, with some modification, included in Bill C-59, the Fall Economic Statement (FES) Implementation Act, 2023. Bill C-59 is currently at second reading.

Notwithstanding that the FES announced an additional incentive (a $10 million capital gains exemption for a limited number of years) for those using this method of business sale, Bill C-59 did not contain that particular measure. So, we can expect to see some more tweaks to the existing framework to reflect this. Bill C-59 deems the EOT measures to have come into force on January 1, 2024.

Requirements and rules as they stand

The main requirements are set out in definitions of the terms "EOT", "qualifying business", "qualifying employees" and "qualifying business transfer". This article is not intended to deal with these in detail but rather to provide an overview of how the rules operate.

An EOT is an irrevocable trust that must be a Canadian resident (not a deemed Canadian resident) trust. The EOT acquires and holds shares of a qualifying business(es) exclusively for the benefit of employees/ former employees/their estates (if permitted by the trust terms). The qualifying business must be a corporation that at the time of acquisition is a CCPC that 90% or more of the fair market value is attributable to assets used principally in an active business carried on by it or a corporation controlled and wholly-owned by it. The vendor must be at arm's length with the trust and the EOT must acquire control of the subject corporation. The rules also provide governance restrictions on the qualifying business so that not more than 40% of the directors can be prior owners (or related to prior owners) of 50% or more of the corporation's debt or fair market value of any class of shares.

Beneficiaries of an EOT are either current employees (see clause (b)(i)(A) of the definition of EOT) or, if the trust permits, individuals or the estate of an individual who is a former employee (clause (b)(i)(B) of the definition). Beneficiaries cannot own (directly or indirectly) 10% or more of the FMV of any class of shares or 50% of any class of shares alone or together with related persons. And they could not have owned 50% or more of the FMV of the shares or indebtedness of the qualifying business at the time of the transfer.

Capital and income interests of each beneficiary must be determined "in the same manner" as the other beneficiaries "based solely on" specified criteria (the "distribution criteria"). The three distribution criteria are: hours of employment service; total remuneration up to a cap (twice the highest marginal tax bracket); and, total period of service. While these trusts are discretionary trusts, no other criteria than the distribution criteria can be applied by the trustee(s) to determine a beneficiary's entitlement to distributions under an EOT. The trustees are prohibited from exercising their discretion to act in the interests of one beneficiary (or group of beneficiaries) to the prejudice of another beneficiary (or group of beneficiaries). Ongoing, 90% or more of the fair market value of the property of the EOT must be attributable to shares of a qualifying business(es) that the EOT controls.

There are specific rules relating to the governance of the trust and who can be a trustee of an EOT to balance the interests of the vendor and purchasing employees so that the business transfer occurs on an arm's length basis. And as noted above, there are also limitations on the participation of the vendor or persons related to the vendor as beneficiaries and limits on the share holdings of employee beneficiaries.

Benefits of using EOTs

In addition to a limited time 10-year capital gains exemption for the vendor announced in the FES, the rules extend the capital gains reserve to 10 years from 5 years, allowing the vendor to recognize gains over a longer period of time where the purchase price is paid over a longer period. The trust could finance the purchase of a qualifying business using a shareholder loan from the qualifying business without the application of shareholder loan rules (in subsection 15(2)) and deemed interest benefit rules (in subsection 80.4(2)) so long as the loan is repaid within 15 years (see subsection 15(2.51) and paragraph 80.4(3)(c))

An EOT is excluded from the 21-year deemed disposition rule in subsection 104(4), allowing the EOT to hold shares of the business for the benefit of employees indefinitely without tax consequences. That said, it is possible for fundamental changes (such as, ceasing to control the business, business asset sales involving all or substantially all of the qualifying business' assets, winding up, amalgamation or merger of the business) to occur where more than 50% of the beneficiaries of the EOT who are current employees of the business approve.

An EOT is excluded from the definitions of “employee benefit plan” and “employee trust”, allowing income distributions from EOTs to be characterized not as income from employment but rather as dividends. As well, it would seem that subsection 107(2) would allow rollouts of property to beneficiaries of an EOT in satisfaction of a capital interest in the trust provided that limitations on share ownership by beneficiaries meet the requirements, the distribution criteria is applied to determine the amount of the distribution and this is applied in the same manner as the other beneficiaries.

What is interesting from an insurance planning perspective

Will the terms of these trusts enable employee beneficiaries to participate in the growth in value of a business by recognizing a portion of this value (computed with reference to the distribution criteria) at the time of death or retirement as an amount payable to the former employee or their estate? Where the triggering event is death, life insurance could be used to fund the “buy-out” of the capital interest in the trust that accrues to the employee, in such a case.

Also, given that the sale of the business to an EOT will involve a longer period of time for the vendor to be bought out, insuring the key employees of the business may be a way of ensuring the debt to the vendor is repaid and the business can continue.

Unchartered territory

These are early days for this new vehicle. While US and the UK have rules and incentives for sale of a business to employee ownership trusts, the Canadian framework is somewhat different. However, the motivations for using this method of business transfer would appear to be similar.

Business owners who:

- want to maintain local employment or benefit communities where their company currently operates and not sell to a third-party, competitor or investment fund;
- have no family members interested in taking over the business; or
- have no key employees capable of financing a buy-out on their own,

may consider this option.

FOOTNOTE:

Should you wish to discuss this or any other TOMPKINSights article, please contact florence@tompkinsinsurance.com