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TAX MATTERS

New Employee Ownership Trusts may have a role in business transition

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My grandfather used to say: "When one door closes, another always opens." He was a wise man – but a terrible cabinet maker. Whether you're a cabinet maker, or own a business of a different kind, you likely realize that a few tax doors have closed in recent years. But the 2023 federal budget tabled last week did open another door that could help with your business succession planning. I'm talking about Employee Ownership Trusts (EOTs), which will come into effect on Jan. 1, 2024.

EOT Explained

An EOT is a trust that makes it possible for a company to become owned by its employees. An EOT is set up by the company's existing owners, often as part of an exit or succession strategy, or by the founders of a new business who'd like the company to be employee-owned.

If you want to establish an EOT, you'd sell shares of your company to the EOT for fair market value. Under the new rules, a trust is considered an EOT if it has two sole purposes: (1) to hold the shares of a qualifying business for the benefit of eligible employees, and (2) to make distributions to employee beneficiaries using a formula that takes into account each employee's length of service, remuneration, or hours worked (otherwise, all eligible employees must be treated the same).

With an EOT, the employees don't actually own shares directly, so there's no participation by an employee in the future growth in value of the shares. Rather, they earn a portion of the earnings of the business distributed as dividends from the EOT.

Further, employees don't put up any cash to purchase the shares you'll be selling to the EOT. The cash needed by the EOT to purchase your shares will typically come from the business itself over time, paid as dividends, or a loan, to the EOT.

EOT Nuances

It's important to know that an EOT must acquire a controlling interest in your company. Your business will qualify for EOT ownership if it's a Canadian-controlled private corporation, meeting

the condition that all, or substantially all, of the assets of the company are used in an active business carried on in Canada.

As for governance, the trustees of the EOT will control the shares owned by the EOT and those folks must be Canadian residents and must stand for election by the employee-beneficiaries every five years. And to ensure independence from former owners, anyone who previously held a significant economic interest in the business cannot account for more than 40 per cent of trustees of the EOT, directors of the board of any company controlled by the EOT, or directors of the board of any corporation serving as a trustee. Clear as mud?

When it comes to employees, employee-beneficiaries will include all employees of the business, with the exception of those who currently, or in the past, held a significant economic interest in the company or those who haven't worked at the company for a reasonable probationary period of up to 12 months. It won't be possible to distribute the shares of the business out of the EOT to employees but, as I mentioned, employees can receive a share of the profits as dividends from the EOT.

How the federal budget affects small business succession plans

EOT Benefits

There are tax and non-tax benefits to EOTs. As for the tax benefits, the new rules will allow you to spread the tax on any capital gain from the sale to the EOT over a period as long as 10 years, which is an increase to the normal five-year "capital gains reserve" that is allowed on the sale of assets when payment is collected over time.

In addition, the EOT can borrow funds from the company to make payment to you for the shares, and that loan will not be subject to the usual shareholder loan rules that could include the loan as taxable income to the shareholder if it's not repaid within one year.

As a final tax benefit, trusts are normally subject to a 21-year rule that deems the trust to have sold its assets every 21 years, but an EOT will not be subject to this rule.

An EOT has other benefits as well. It can allow you to preserve the legacy that you've created and protect the culture and values that are so important to your business. Selling to a third party can change the culture dramatically. And the EOT also provides a more certain exit strategy than other approaches, which could fall apart after intense negotiations.

Finally, there's evidence that employee-owned businesses are more resilient, experience lower employee turnover and are differentiated when hiring talent.

Make sure you speak to your trusted advisers about EOTs since there are lots of things to consider, and since I've simplified the rules here.

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