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Tax Alert — Canada

Finance releases details on the $10m capital gains exemption on sale to employee ownership trust

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 2 May 2024, Bill C-69, *Budget Implementation Act, 2024, No. 1*, received first reading in the House of Commons. Bill C-69 implements the measures contained in the notice of ways and means motion that was tabled on 30 April 2024, including the temporary exemption from taxation of the first $10 million in capital gains realized on the sale of a business to an employee ownership trust (EOT).[1] This measure was first announced in the 2023 fall economic statement and confirmed in the 2024 federal budget.

In this Tax Alert, we provide a brief overview of the temporary capital gains exemption and related EOT measures included in Bill C-69. This new exemption will operate as an additional incentive to the original proposals relating to the sale of a business to an EOT, which were included in Bill C-59, *Fall Economic Statement Implementation Act, 2023*. For a discussion of the original proposals, see EY Tax Alert 2023 Issue No. 47, *Finance releases draft legislation to facilitate the use of employee ownership trusts*.

Background

In general terms, an EOT is a form of employee ownership where a trust holds shares of a corporation for the benefit of the corporation's employees. This type of trust can be used to facilitate the purchase of a business by its employees without employees having to pay directly to acquire the shares.

[1] For information on other income tax measures included in Bill C-69, see EY Tax Alert 2024 Issue No. 27.

Building a better working world

The 2023 federal budget proposed new rules to facilitate the creation and use of EOTs. Subsequently, the 2023 fall economic statement proposed to temporarily exempt the first $10 million in capital gains realized on the sale of a business to an EOT from taxation, subject to certain conditions.

Bill C-59, which received first reading in the House of Commons on 30 November 2023, contains the original legislative proposals relating to the use of EOTs to purchase shares of a business. Broadly speaking, the Bill C-59 legislative proposals (i) define the conditions for a trust to qualify as an EOT; (ii) extend the capital gains reserve from 5 to 10 years for qualifying sales to an EOT; (iii) create an exception to the current shareholder loan and deemed interest benefit rules; and (iv) exempt EOTs from the 21-year deemed disposition rule that applies to certain trusts. These amendments apply as of 1 January 2024. Bill C-59 did not include details with respect to the capital gains exemption.

The 2024 federal budget provided further details on the capital gains exemption, which are now included in Bill C-69 (with some modifications, as indicated below).

Except where noted otherwise, the Bill C-69 amendments are deemed to have come into force on 1 January 2024 so that they apply as of the same date as the original proposals in Bill C-59.

Qualifying conditions

An individual (other than a trust) can claim a deduction for up to $10 million in capital gains on the sale of shares to an EOT where all of the following conditions are satisfied:

- The individual is at least 18 years old and disposes of shares of a corporation that is not a professional corporation to a trust, or to a corporation wholly owned by the trust;
- The transaction is a qualifying business transfer[2] in which the trust acquiring the shares is not already an EOT or a similar trust with employee beneficiaries (in other words, if the sale is made to a pre-existing EOT (or similar trust), the transfer will not qualify for the deduction);[3]
- The qualifying business transfer occurs between 1 January 2024 and 31 December 2026;
- Throughout the 24 months immediately before the qualifying business transfer, (i) the shares were not owned by anyone other than the individual or a person or partnership related to the individual, and (ii) more than 50% of the fair market value of the shares was derived from assets used principally in an active business;

[2] As defined in proposed amendments to subsection 248(1) of the *Income Tax Act*, which are included in Bill C-59.
[3] The intent of this condition is to ensure employees of the target business wishing to acquire the business and establish a new EOT are not bidding against a previously established EOT, which may have greater access to financing.

- No individual has previously claimed the deduction in respect of a disposition of shares that derived their value from the same 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 business on a regular and continuous basis for at least 24 months;

- At the time of the qualifying business transfer, at least 75% of the beneficiaries of the trust are resident in Canada (i.e., this condition has been modified from the more stringent 90% requirement originally stated in the 2024 federal budget); and

- The trust, any purchaser corporation owned by the trust, and the individual jointly elect for the deduction to apply and file the election on or before the trust's filing due date for the taxation year that includes the qualifying business transfer. The election must specify the amount of capital gains eligible for the deduction (i.e., the elected amount, which cannot exceed $10 million) and, where more than one individual is eligible for the deduction, the percentage of the elected amount allocated to each individual. The total deduction in respect of a qualifying business transfer cannot exceed $10 million.

The legislative proposals also prohibit an individual who claimed a deduction in respect of a qualifying business transfer to an EOT (and any related individuals) from being beneficiaries of the EOT.

Disqualifying event

A disqualifying event occurs if (i) the trust that participated in the qualifying business transfer loses its status as an EOT, or (ii) less than 50% of the fair market value of the shares of the qualifying business is attributable to assets used principally in an active business at the beginning of two consecutive taxation years of the qualifying business. The Department of Finance Explanatory Notes provide examples of disqualifying events, including an example of a qualifying business leasing premises that were previously used as part of the active business to a third party.

The consequences of a disqualifying event depend on whether it occurs within or after 24 months of the qualifying business transfer:

- If the disqualifying event occurs within 24 months of the qualifying business transfer, the capital gains deduction is not available and would be retroactively denied if an individual has already claimed it. The trust, the purchaser corporation (if applicable), and the taxpayer are jointly and severally, or solidarily, liable for the tax payable by the individual as a result of the deduction being denied due to a disqualifying event occurring within the first 24 months after a qualifying business transfer.

- If the disqualifying event occurs more than 24 months after the qualifying business transfer, the EOT is deemed to realize a capital gain (equal to the total elected amount of exempt capital gains) in the year the disqualifying event occurs. Consequently, the trust would be solely liable for tax realized on the deemed capital gain that arises on a disqualifying event occurring more than 24 months after a qualifying business transfer.

It should be noted that the reference to 24 months represents a change from what was stated in the 2024 federal budget. Specifically, the 2024 federal budget stated that the above consequences would depend on whether the disqualifying event occurs within or after 36 months (rather than 24 months) of the qualifying business transfer.

Anti-avoidance

A number of complex anti-avoidance rules provide that the capital gains deduction will not be available in respect of a qualifying business transfer in certain circumstances. Broadly speaking, the anti-avoidance rules are designed to ensure that:

- The deduction is only available in situations involving a genuine qualifying business transfer;
- A business is not split for purposes of claiming capital gains deductions in respect of multiple qualifying business transfers;
- Amounts that could have been paid as dividends are not converted into capital gains eligible for the capital gains deduction; and
- Taxpayers claiming the deduction make all required tax filings in a timely manner.

Alternative minimum tax (AMT)

The legislative proposals exempt EOTs from the application of AMT, effective for taxation years that begin after 31 December 2023.

In addition, as currently worded, the legislative proposals provide that exempted capital gains on the sale of a business to an EOT will not be subject to AMT. This also represents a modification from what was stated in the 2024 federal budget. Specifically, the 2024 federal budget stated that the exempted capital gains on the sale of a business to an EOT would be subject to an inclusion rate of 30% for AMT purposes, which parallels the AMT treatment with respect to gains eligible for the lifetime capital gains exemption.

Reassessment period

Where an individual has claimed the capital gains deduction, the individual's normal reassessment period for a taxation year in respect of the deduction will be extended by three years.

Worker cooperatives (currently only included as a proposal in the 2024 federal budget)

The 2024 federal budget proposed to expand qualifying business transfers to include the sale of shares to eligible worker cooperative corporations. This measure would allow an individual to claim a capital gains deduction on the sale of a business to a worker cooperative, where the necessary conditions are satisfied. Bill C-69 does not contain details with respect to this proposal.

Key takeaways

The exemption for up to $10 million in capital gains on the sale of shares to an EOT provides business owners with a significant incentive to sell to an EOT, rather than to a third-party buyer. A number of business owners have been eagerly awaiting details on this measure, and the legislative proposals provide a number of important particulars, including some modifications from what was stated in the 2024 federal budget.

In addition, the 2024 federal budget proposal to increase the capital gains inclusion rate from one-half to two-thirds for capital gains realized on or after 25 June 2024[4] makes this exemption even more valuable and may significantly increase uptake of these arrangements, particularly for smaller-sized transactions.

Access to this capital gains exemption is only temporary, so this is a time-limited opportunity for business owners considering the sale of their business. Specifically, the exemption will only be available for qualifying business transfers to an EOT that occur after 2023 and before 2027. It is therefore advisable for business owners to review their succession plans and consider whether a sale to an EOT would be beneficial in their circumstances.

[4] For individuals, the inclusion rate will increase from one-half to two-thirds on the portion of capital gains realized in the year that exceeds $250,000, for capital gains realized on or after 25 June 2024. For further discussion on the proposed change to the capital gains inclusion rate, see EY Tax Alert 2024 Issue No. 28.

Learn more

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