Employee Ownership Trusts (EOT)

Camilla Advisory Group Inc.

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Why an Employee Ownership Trust (EOT)?

1. Allows employees to participate in the success of their employer.
2. $10 million capital gains exemption.
3. Stronger employee engagement etc. compared to non-employee-owned competitors.
4. Easing succession planning for business owners in Canada - Budget 2023*

"Employee Ownership Trusts enable employees to share in the success of their work. They support participation in business decisions and allow workers to receive their share of profits. With more than 75 per cent of small business owners planning to retire in the next decade, Employee Ownership Trusts can also give business owners an alternative succession option."

Ideal Business for an Employee Ownership Trust would include the following characteristics

Characteristics of a business suitable for an Employee Ownership Trust

- An owner seeking to sell and leave a legacy
- $2million - $75million EBITDA and 25+ employees
- A mature business.
- Strong management team.
- The business historically generated strong non-cyclical cash flow.
- Predictable future cash flow.
- Strong balance sheet.
- Future capital needs are minimal.

Employee Ownership Benefits

- Allows employees to participate in the long-term growth of the business
- Succession planning tool
- Attraction and retention of key employees
- Recognition of past employees' contributions
- Employees are more conscious of the financial success of the company

Employee Ownership Benefits (continued)

- Foundation for an ownership transition and founder legacy
- Source of cash for founder (Financing available through financial institutions)
- A study by the National Center for Employee Ownership (NCEO) found ESOP companies had reduced turnover and received more job applications
- A NCEO study also found ESOP participants have double the retirement savings at retirement than non-ESOP retirees

ESOP Employees are Engaged

Engaged employees think like “owners”, not like “employees”

Owner	**Employee**
Cash Flow Risk Revenue Growth Market Share Economy Employee Retention Cost Control	Paycheck Benefits Recognition Job Security Friday Work Environment Opportunity

Timeline of Canadian Employee Ownership Trust Legislation Development

Apr. 2022: Budget 2022 committed to a review of Employee Ownership structures

Nov. 2022: Fall Economic Statement 2022 committed to legislation

Apr. 2023: Budget 2023 produced draft Employee Ownership Trust legislation

Aug. 2023: Revised Employee Ownership Trust legislation

Nov. 2023: Fall Economic Statement 2023 produced final legislation

Jan. 2024: Employee Ownership Trust legislation introduced and became law in June 2024

April 2024: Details of $10 million capital gains exemption announced

Canada was the last G7 country to introduce legislation regarding Employee Ownership. UK and US structures have been successful. Canada's rules are a hybrid of the UK and US approaches.

A Founder Selling their Business is likely the Biggest Transaction of their Life

- In most cases building the business took years of hard work and dedication.
- Countless hours and resources went into the team that shares the vision with the founder.
- Fair value is important and giving up control is always a concern
- Giving up control to a collective group of individuals a founder knows may be easier than a stranger, especially with board checks and balances by the founder.
- An EOT is ideal for founders that think about their business as more than money and want to create something meaningful alongside people they trust and ultimately leave a legacy.
- An EOT is a great succession planning tool and an alternative to selling to Private Equity, a competitor or a management buyout.

Employee Ownership Trust Benefits

Benefits of selling the business to an Employee Ownership Trust

- Primary Benefit is saving of approx. $3 million in tax with a $10M capital gains exemption.
- Leverage the flexible structure to set up the EOT in the way that best suits the business.
- Transform the lives and futures of your team by making employees co-owners.
- Double deferral period for Capital Gains: Owners receiving sale proceeds over time have up to 10 years (versus 5) to claim the capital gains reserve/deferral resulting from selling QB shares to an EOT for no more than FMV.
- Shareholder Loans: A qualifying business can lend to an EOT to purchase its shares with a 15-year repayment period. Note that under rules prior to exemption for EOT, shareholders must include shareholder loans in their income if not repaid by the end of the following calendar.

Requirements of an Employee Ownership Trust in Canada

An EOT is exempt from the 21-year deemed disposition rule for Trusts. There are three main requirements:

1. The Trust holds the shares of the Qualifying Business for the benefit of the employee beneficiaries. *
2. The Trust makes distributions to current and former employee beneficiaries under a distribution formula that can only consider remuneration, hours workers, and years of service.
3. The Trust needs to be a resident in Canada.

* Qualifying Business: means a Canadian-controlled private corporation, where (i) 40% or less of its' directors own half or more of the debt or fair market value (FMV) of any class of shares (directly, indirectly, or with any related or affiliated persons or partnerships); and (ii) it deals at arm's length and is not affiliated with any persons or partnerships who own half or more of its debt or the FMV of its shares

How Employee Ownership Trusts Work

Each employee ownership transaction typically consists of five parties:

Shareholder (s)

The decision to convert a business to employee ownership rests in the hands of the existing shareholder(s).

Buyer/ Trust

An Employee Ownership Trust becomes the buyer of the shares. The Trust allows employees to own the shares as a group in a tax-effective way, without requiring individual employees to purchase and manage them. The Trust manages the responsibilities of ownership.

Corporation

The corporation is the entity being sold. The Corporation provides the cash flow to service the debt used to purchase the Corporation.

Employees

The employees are the ultimate beneficiaries of the corporation's future profit and value. All employees are included in these plans at no cost to them personally. The structure of the Trust determines how and when each employee will benefit.

Financial Institution

Since employee owners do not bring their own cash to the purchase of the corporation, employee ownership transitions are 100% debt financed. Lender participation and seller financing are essential to make these transactions possible.

Qualifying Business Transactions

1. **Fair Market Value**
   The sale price must not be more than the fair market value of the corporation.

2. **Shares sold**
   The shares must be sold to either the Employee Ownership Trust or a holding company owned by the Trust.

3. **Control**
   The Employee Ownership Trust must own the controlling interest in the company.

4. **One time transaction**
   The transaction to become employee owned only happens once.

5. **Perpetual compliance**
   The Employee Ownership Trust must always remain compliant to the legislation. The business FMV is less than 50% attributable to assets principally used in an active business at the beginning of the two consecutive taxation years following the transaction.

EOT Draw-Backs and counter arguments

For the owner:

- X Business owner to finance part of sale proceeds.

  (The $10 capital gain exemption partially offsets this draw-back)

- X Giving up control of the business.

  (Alternative board structure with the use of independent directors can be a used by the owner as part of the transaction)

For the employee:

- X Paying back the loan from the business owner reduces distributable profit during the repayment period.

  (Future distributions and capital appreciation after the loan is paid back is a real benefit to the employee)

Ownership and Board Requirements of a Sale to an EOT

Seller(s) cannot retain more than **49% of the company shares**

Seller(s)cannot retain more than **40% of the trustee vote**

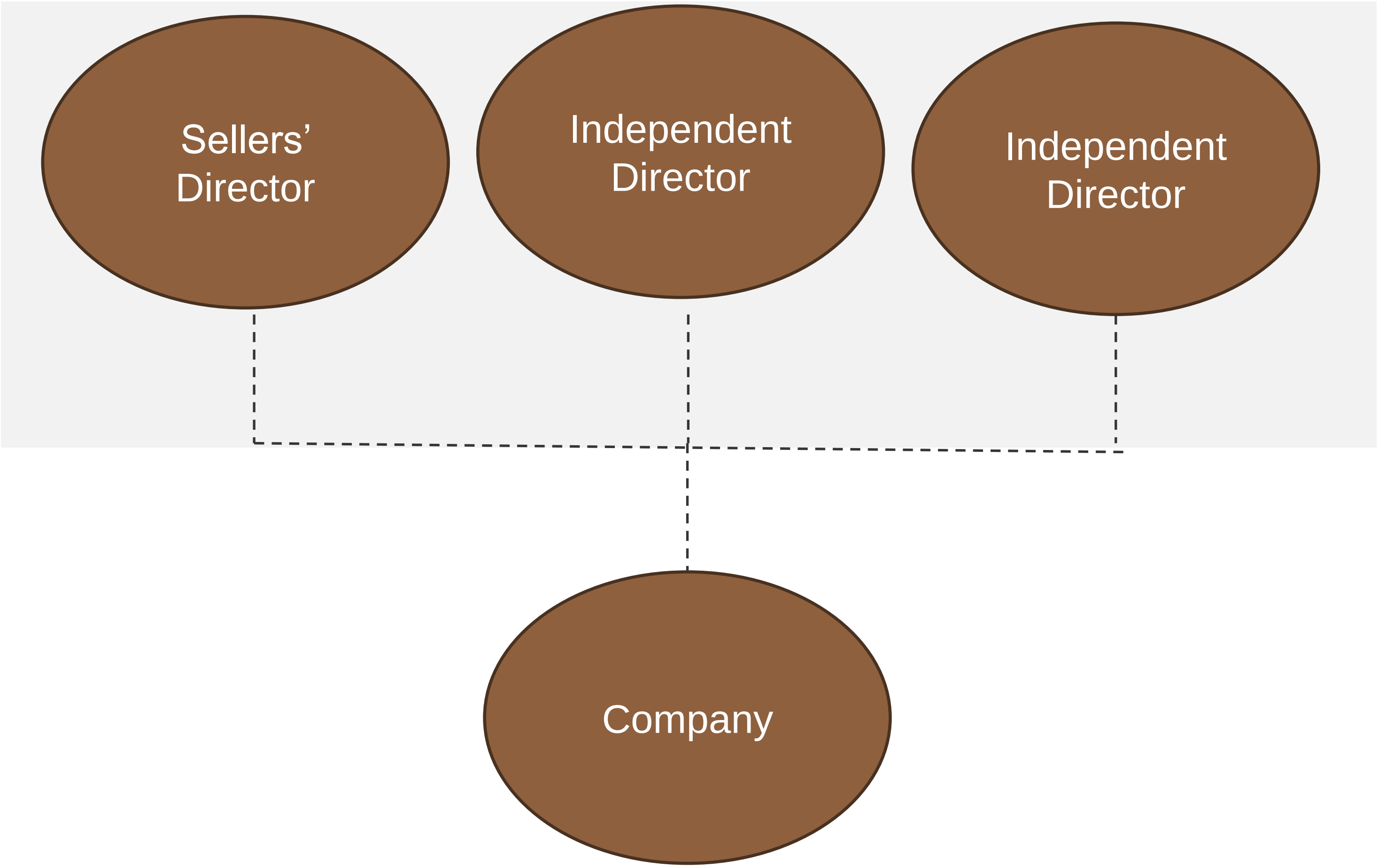
1/3 of the Trustees must be currently employed beneficiaries

Seller (s) cannot control more than **40% of the directors of the Corporation**

Certain private equity firms (family offices) in Canada have shown an interest in partnering with the sellers in a sale to an EOT and are willing to take a minority interest in the company. Management teams can also purchase a portion of the equity. If one manager owns more than 10% of the company, they are not eligible to participate in the EOT.

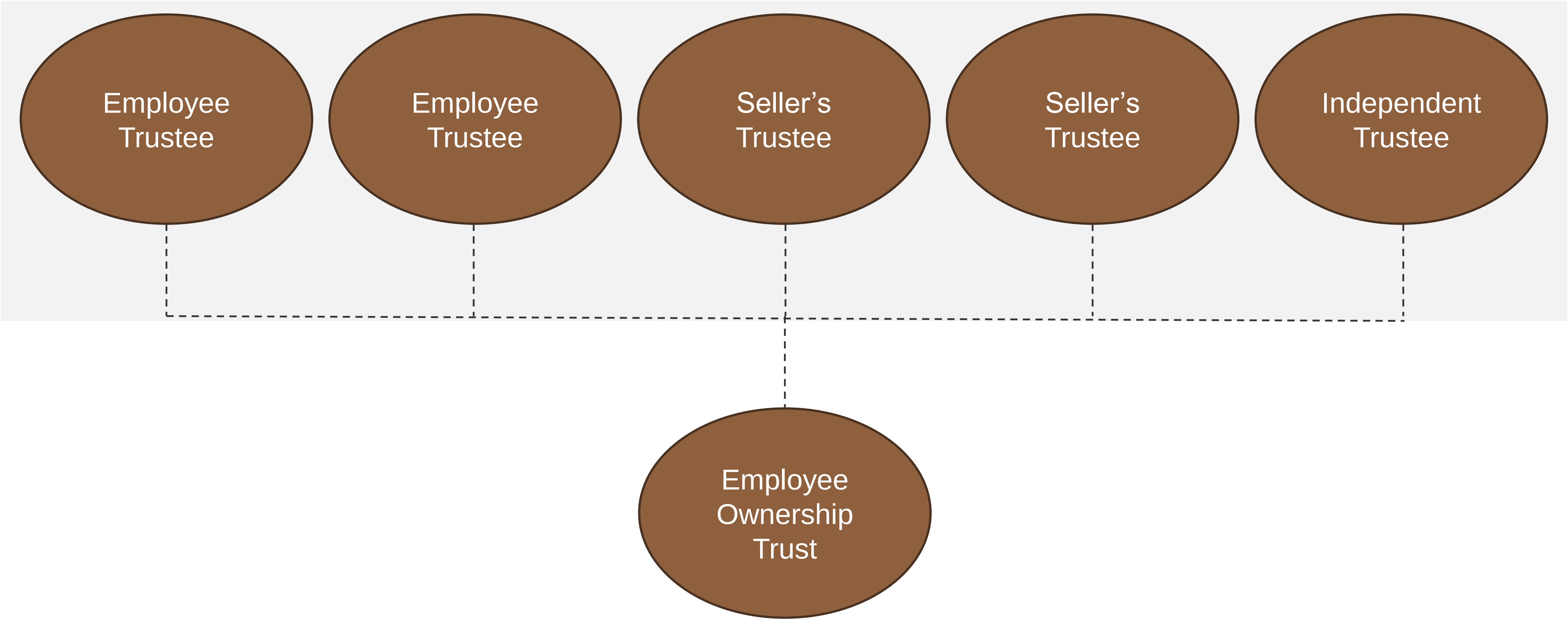
Example Company Board of Directors

(Seller is not more than 40%)

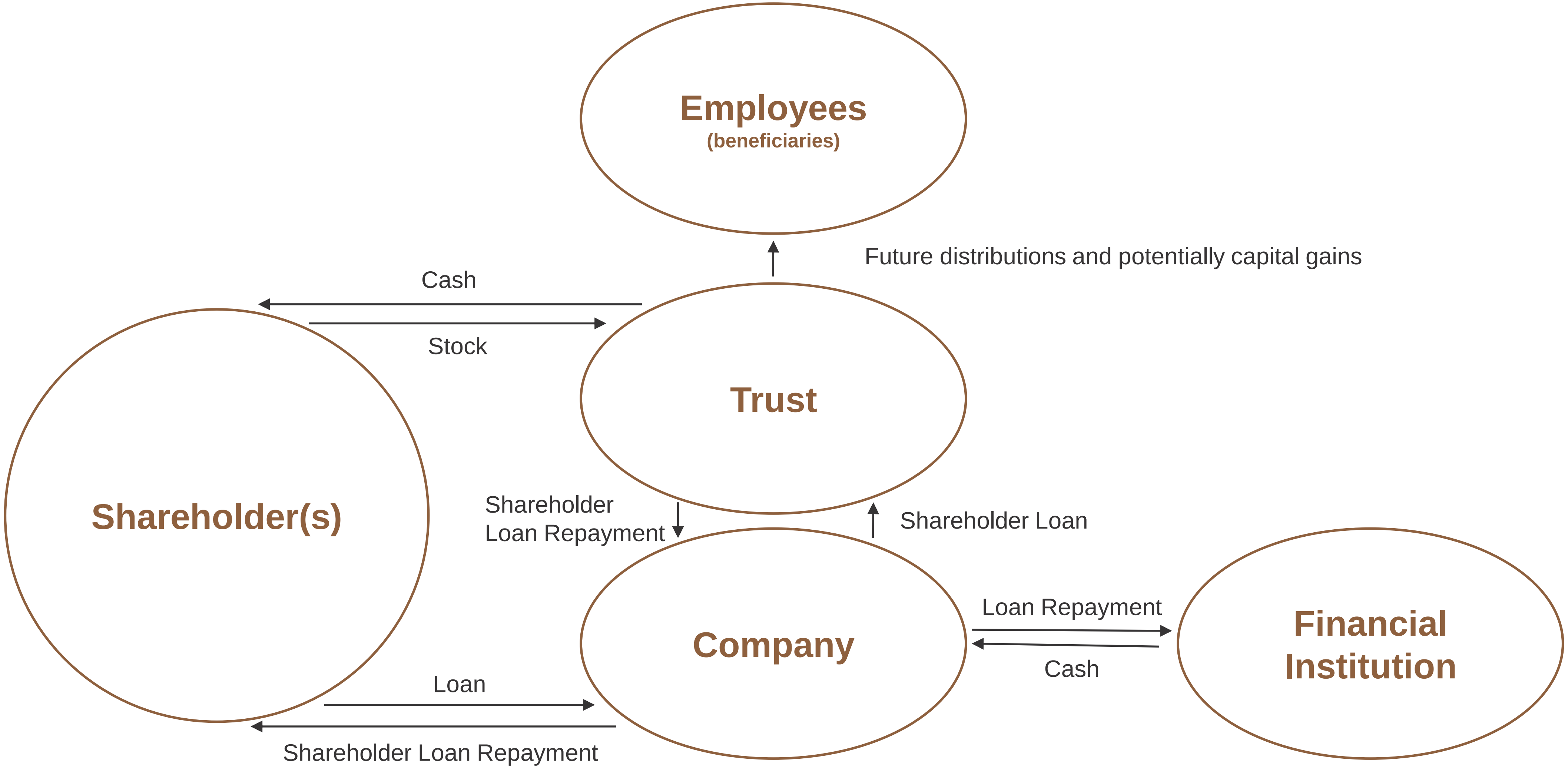


Example Board of Trustees Structure

(Seller's are not more than 40% and employees are more than 1/3)



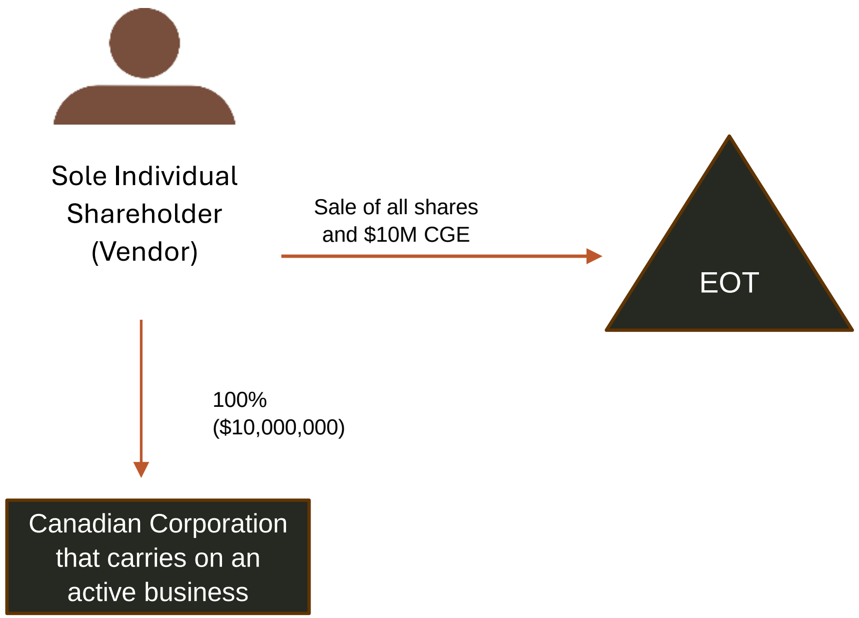
Employee Ownership Trust Flow of Funds



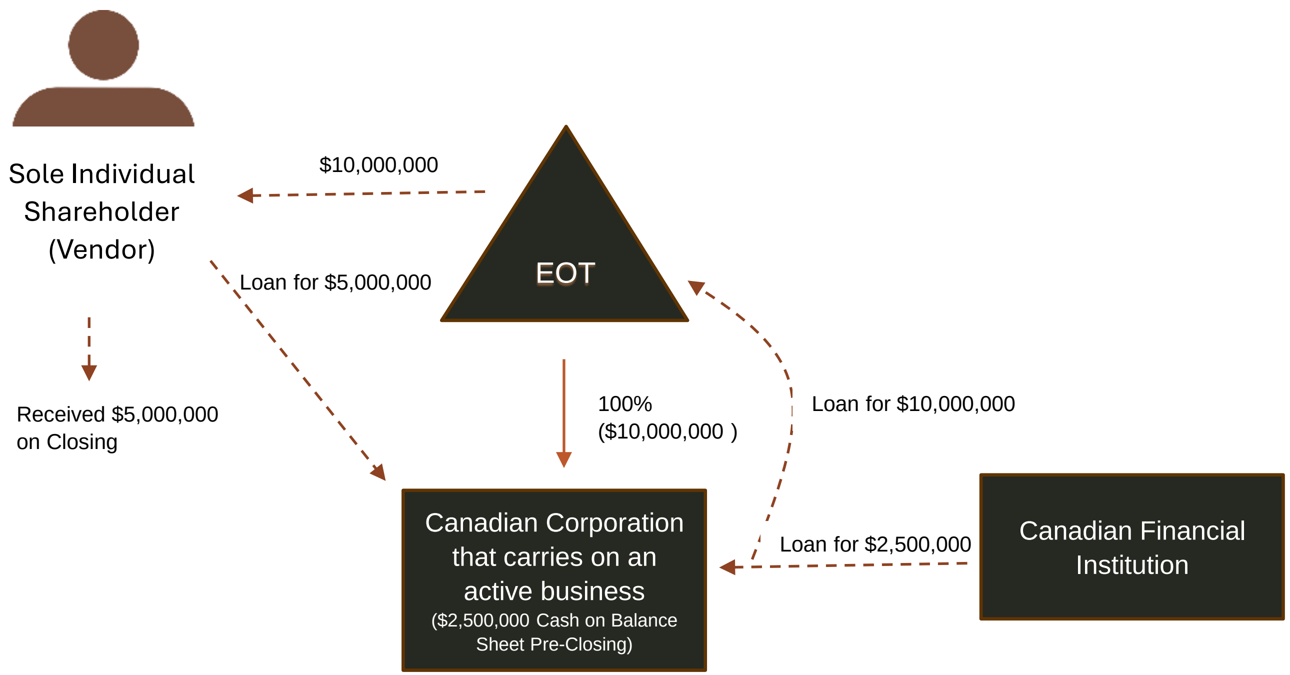
Simple Example of EOT Flow of Funds

(For a $10,000,000 sale price of the business)

Pre-Closing:



Post-Closing:



Eligible Beneficiaries of an Employee Ownership Trust

Current Employees

- ✓ All qualifying employees can become a beneficiary, this would be based on a period of time specified by the Trust.
- ✓ New employees would need to pass a probationary period to become a beneficiary.
- ✓ The interests of each beneficiary must be determined by a formula to ensure equitable application. The formula includes a combination of hours, total remuneration and period of employment service.

Former Employees

- ✓ Terminated or deceased employees may retain benefits through their estate (based on the Trust agreement).
- ✓ Retired employees may maintain their interest in the Trust and benefit in the future instead of at the time of their retirement.

In-Eligible Beneficiaries of an Employee Ownership Trust

The following groups are excluded as beneficiaries to an Employee Ownership Trust:

- Current employees in a probationary period to a maximum of 12 months.
- Former owners who owned 50% or more, and related persons, are excluded from participation in the Trust.
- Any person who owns 10% or more of the fair market value of the corporation is excluded from participation in the Trust.

Distributions in an Employee Ownership Trust

The formula(s) for equitable application must be based on the following criteria:

- Total hours of employment services
- Total salary, wages and other remuneration paid
- Total period of employment service provided

**The formula must include one of the above criteria and cannot include anything but these three criteria.*

**There is cap on equitable distribution of 2 times the maximum tax bracket ($450k).*

The formula for distribution of profit can be different from the formula for the distribution of equity. However, both are restricted to the same criteria.

If an employee ownership trust is created and includes both current and former employees as beneficiaries there could be four different distribution formulas:

1. For distributing income to current employees.
2. For distributing capital to current employees.
3. For distributing income to former employees.
4. For distributing capital to former employees.

Capital Gains Exemption and Reserve

First $10 Million in capital gains realized on the sale of a business to an Employee Ownership Trust is exempt from tax

- Incentive is in effect for 2024, 2025, and 2026.
- The exemption will be available to an individual on the sale of shares to an EOT where certain conditions are met (e.g., the sale is a qualifying business transfer in which the trust acquiring the shares is not already an EOT or a similar trust with employee beneficiaries; at any time prior to the transfer, the individual (or their spouse or common-law partner) has been actively engaged in the qualifying business on a regular and continuous basis for a minimum period of 24 months).
- If a disqualifying event (e.g., the loss of EOT status) occurs within 36 months of the transfer, the exemption will not be available, and if the individual has already claimed the exemption, it will be retroactively denied. If the disqualifying event occurs more than 36 months after the transfer, the EOT will be deemed to realize a capital gain equal to the total amount of exempt capital gains.
- In addition, to help sellers match the tax burden with cash flows, payment of the capital gains tax on the sale of the business can be spread over ten years. A minimum of 10% of the proceeds need to be brought into income each year over the 10 year period.

EOT Pitfalls

- Lack of communication
- Economic challenges
- Reduction in value of the business and the shares
- Financial literacy is lacking
- Lack of free cash flow

EOT Implementation

Communication is key to success

(Explain clearly to employees the difference between their role as a shareholder and their role as an employee of the company)

Steps

- Develop employee EOT package including FAQs
- Develop employee presentation
- Identify EOT champions
- Identify EOT administrators
- Plan employee meeting
- Conduct employee meeting

Camilla Advisory Group – Services

1. **Fractional Chief Financial Officers**
   We have several CFOs that are available to help businesses grow and succeed.

2. **Merger and Acquisition Advisory**
   Providing both buy side and sell side advisory services

3 **Employee Share Ownership Plans (ESOPs)**
   Design and Implementation of traditional ESOPs.

4. **Employee Ownership Trusts (EOTs)**
   Design and Implementation of the new EOTs.

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