Note • Fall Economic Statement 2023 Measure

Legislative Costing Note

Supporting Employee Ownership Trusts

Published on April 23, 2024

As initially proposed in Budget 2022, the government introduced tax rules for the creation of employee ownership trusts (EOT) in Budget 2023 to give business owners an alternative succession option. In response to stakeholder feedback, Fall Economic Statement (FES) 2023 proposes to temporarily exempt up to $10 million in capital gains realised on the sale of a private business to an EOT from taxation in the 2024, 2025 and 2026 tax years.

Further, Budget 2024 proposes changes to capital gains taxation that will impact the amount of capital gains a business owner could exempt following the sale of their private business to an EOT.

- An increase to the inclusion rate from one-half to two-thirds on capital gains realised annually above $250,000 by individuals and on all capital gains realised by corporations and trusts.
- An increase in the lifetime capital gains exemption limit to $1.25 million, starting June 25, 2024.
- A Canadian Entrepreneurs' Incentive which will reduce the inclusion rate to one-third on a lifetime maximum reaching a value of $2 million in eligible capital gains by January 1, 2034.
- EOT to be fully exempt from the Alternative Minimum Tax.

Combined with Budget 2024 proposed measures, the PBO estimates that the FES 2023 measure to temporarily exempt up to $10 million in capital gains realised on the sale of a private business to an EOT will decrease tax revenues by $23 million from fiscal year 2023-24 to 2026-27.

5-Year Cost

$ millions

Fiscal year	2023-2024	2024-2025	2025-2026	2026-2027	2027-2028	Total
Total cost	2	7	7	7	0	23

Notes

· Estimates are presented on an accrual basis as would appear in the budget and public accounts.
· A positive number implies a deterioration in the budgetary balance (lower revenues or higher spending). A negative number implies an improvement in the budgetary balance (higher revenues or lower spending).
· Totals may not add due to rounding.

Estimation and Projection Method

The impact of the temporary Capital Gains Tax exemption is based on the estimated weighted average of federal tax revenues exempted for each Canadian Controlled Private Corporations (CCPC) sold, and the estimated number of private corporations sold to an EOT over the 2023-24 to 2026-27 fiscal year horizon.

PBO used administrative (T2) corporate income tax data to estimate the total amount of capital gains realised for each CCPC sold between the 2014 and 2021 tax years.[1] Within each industry classification, CCPCs were classified into one of three groups based on their estimated capital gains realised resulting from the sale of the private business: less than $1 million, between $1 million and $10 million, and more than $10 million.[2]

In each group, the PBO estimated the average amounts of capital gains realized for each CCPC sold, as well as the effective federal tax rates associated with them.[3] The average capital gains amounts were then adjusted to account for a behavioral response that increases the realization of capital gains following a temporary decrease in the effective tax rate.

[1] The data comprises the tax filings of all corporations that file a tax return in Canada.
[2] Multiple years were included to achieve a significant sample size. No indexation adjustments were made due to the absence of a clear trend over the years. Negative capital gains were excluded.
[3] The effective federal tax rates consider the full claim of the lifetime capital gains exemption.

By using the difference between the effective federal tax rates with and without the $10 million exemption, it was possible to estimate the average tax revenues that would be exempted per sold CCPC.

Based on the number of CCPCs sold in each group, a weighted average of exempted Capital Gains Tax revenues for each CCPC sold was estimated for each industry classification.

The PBO estimated the number of private companies sold to an EOT based on the trend that emerged after the UK government introduced EOTs and a capital gains tax exemption in 2014. This estimate is based on the proportion of UK private companies sold to an EOT by industry and size (measured by the number of employees).

Sources of Uncertainty

The estimate is based on historic values, which may differ in the future. It is linked to the number of private businesses sold, their valuation at the time of sale as well as the number of shareholders/owners selling a CCPC. The number of private corporations sold to an EOT may differ to observed UK experience due to a potentially different willingness by business owners to sell to an EOT, the temporary nature of the Capital Gains Tax exemption in Canada, as well as the order in which Budget 2024 measures are applied. The estimated amounts of capital gains realised considers a behavioral response, but the extent of this response remains uncertain.

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Data Sources

Assets, liabilities, shareholders' equity and retained earnings
Statistics Canada, Administrative (T2) corporate income tax data (schedules 100 and 200)

Behaviour response for capital gains realizations
National Bureau of Economic Research, Permanent and Transitory Responses to Capital Gains Taxes: Evidence from a Lifetime Exemption in Canada, February 2021

Number of Employee Ownership Trusts, 2014 to 2019
Employee Ownership Association

Sectoral distribution of employee-owned firms, 2019
White Rose Employee Ownership Centre, Employee Ownership In Britain: Size and Character

Business Population Estimates for the United Kingdom and Regions, 2014 to 2019
United Kingdom Statistics Authority

Canadian Business Counts, by employment size and industry
Statistics Canada (Table 33-10-0806-01) Canadian Business Counts, with employees, December 2023

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