Employee ownership trusts: Business succession alternative for private businesses in Canada

July 12, 2024

Over the next decade, 76 per cent of Canadian business owners plan to exit their business which represents a potential transition of more than $2 trillion worth of business assets. However, only 9 per cent of business owners have a business succession plan.

If the business will not be transitioned to the next generation of the family, finding a suitable buyer may be difficult. Many business owners consider factors that go beyond maximizing the purchase price to protecting their employees and ensuring the business remains in the community. Canada's Employee Ownership Trust (EOT) regime may provide another exit option for business owners that may address these concerns.

The initial EOT proposals, announced in the 2023 Federal Budget, generated little interest; however, additional tax incentives have been introduced to encourage business owners to consider an EOT as a viable business succession option. EOTs are to be available as of Jan. 1, 2024.[1]

Overview

The goal of an EOT is to encourage the purchase of a business by its employees (through a trust arrangement) without requiring the employees to provide up-front funding. The underlying business provides the funding to the EOT, which then acquires a controlling interest in the qualifying business. Similar arrangements can be found in both the United States and the United Kingdom.

Tax incentives

There are a number of tax measures aimed at facilitating the use of EOTs.

Incentives for the business owner and family

First, in recognition that the business's earnings will be used to fund the purchase price, the normal 5-year capital gains reserve is increased to 10 years. This will be available to all selling individuals.

Second, the government announced a capital gains exemption on the first $10 million of capital gains realized on the sale of a business to an EOT. This incentive was originally set to expire at the end of the 2026 tax year. On April 28, 2026, the government announced that the exemption would be made permanent.

The $10 million capital gain exemption will be available to individuals over 18 years old, where the following conditions are met:

1. Throughout the 24-month period immediately preceding the disposition of the shares (i) the shares were not owned by anyone other than the individual or a person or partnership that is related to the individual and (ii) more than 50 per cent of the fair market value of the shares was derived from assets which were used principally in an active business;
2. Throughout any 24-month period ending before the disposition of the shares, the seller (or a spouse or common-law partner of the seller), was actively engaged on a regular and continuous basis in the business;
3. The EOT or a purchaser corporation owned by the EOT, the seller and any other individual entitled to the capital gain exemption jointly elect, in a prescribed form, for the deduction to apply in respect of the disposition of the shares[2]; and
4. At least 75 per cent of the beneficiaries of the EOT are residents of Canada.

In addition, the capital gain exemption will only be available on disposition of shares that occurs between Jan. 1, 2024, and Dec. 31, 2026, under a “qualifying business transfer”.

A “qualifying business transfer” is a disposition by a taxpayer of shares of a corporation to an EOT or a Canadian-controlled private corporation (CCPC) that is wholly owned by an EOT and which meets all of the following conditions:

1. Immediately before the disposition, all or substantially all the fair market value of the assets of the corporation is attributable to assets that are used principally in an active business carried on by the corporation;
2. At the time of the disposition (i) the taxpayer deals at arm’s length with the EOT and any purchaser corporation (ii) the EOT acquires control of the corporation and (iii) the trust is an EOT, the beneficiaries of which are employed in the business; and
3. At all times **after** the disposition:
    a. The taxpayer deals at arm’s length with the corporation, the EOT and any purchaser corporation; and
    b. the taxpayer does not retain any rights or influence that, if exercised would allow the taxpayer to control, directly or indirectly in any manner whatever, the corporation, the EOT or a purchaser corporation.

Disqualifying event

A disqualifying event with respect to the $10 million capital gain exemption will occur if upon the earliest occurrence of

1. The trust that participated in the qualifying business transfer ceases to be an EOT; and
2. less than 50 per cent of the fair market value of the shares of the qualifying business is attributable to assets used principally in the active business carried on by the business that is controlled by the trust.

The consequences resulting from a disqualifying event will depend on when the disqualifying event occurs:

1. If the disqualifying event occurs within 24 months of the "qualifying business transfer" transaction, the capital gain exemption will be deemed to have never been claimed by the individual(s), subjecting the individuals to tax on the capital gain.
2. If the disqualifying event occurs 24 months after the day of the "qualifying business transfer", **the trust** will be deemed to have realized a capital gain equal to the elected amount included in the prescribed form in the year of the disqualifying amount, subjecting the trust to tax on the capital gain.

Incentives for the EOT and the employees

The EOT will benefit from an exemption from the shareholder loan repayment period and deemed interest benefit rules, which will extend the repayment period from 1 year to 15 years on funds borrowed from the qualifying business to purchase shares in a qualifying business transfer. The deemed interest benefit rule will also not apply to the shareholder loan for this 15-year period.

The EOT will also be exempt from the deemed disposition rules which require certain trusts to pay tax on a deemed disposition of their capital property every 21 years. This will enable EOTs to hold qualifying businesses indefinitely.

Although EOTs, like other personal trusts, will pay tax at the highest personal marginal tax rate on income retained in the trust, trust income that is distributed from the EOT to its employee beneficiaries will be subject to tax in the hands of the beneficiaries. In addition, dividends will retain their character permitting employees to access the dividend tax credit. Unlike earlier proposals, there is no prohibition on an EOT from distributing shares of a qualifying business to its beneficiaries.

An EOT will not be considered to be an employee benefit plan or an employee trust for income tax purposes.

Requirements

1. **EOT residency**: An EOT must be a Canadian resident trust for tax purposes. This requires that the central management and control be in Canada. See "EOT Trustees" below for further information on the requirements imposed on the trustees of an EOT.
2. **EOT beneficiaries**: The EOT must benefit all active employees of the business (and, if desired, may also benefit former employees) other than:
    a. Employees who own (outside of their interest in the EOT) directly or indirectly shares in the qualifying business having a value which is equal

to or greater than 10 per cent of the fair market value of all of the shares of that class (*i.e.* employees with significant ownership outside the EOT).

b. Employees who, alone or together with related or affiliated persons or partnerships, own directly or indirectly shares in the qualifying business having a value which is equal to or greater than 50 per cent of the fair market value of all of the shares of that class (*i.e.* employees related to or affiliated with significant owners).

c. Employees who, immediately before the acquisition of the qualifying business by the EOT, alone or together with related or affiliated persons or partnerships, did not own directly or indirectly shares in or indebtedness of the qualifying business having a value which is equal to or greater than 50 per cent of the fair market value of all of the shares of the capital stock and indebtedness of the qualifying business (*i.e*. employees who were part of, or are related to or affiliated with, the vendor ownership group).

d. Employees who have not completed a reasonable probationary period (not exceeding 12 months), who may be (but are not required to be) excluded.

3. **Limits on EOT distributions**: In making distributions, the EOT must treat all employee beneficiaries in the same manner utilizing a formula based solely on any combination of an employee's length of service, renumeration (which for this purpose is capped at twice the highest marginal income tax bracket), and hours worked. Although there is some flexibility to apply different combinations of the criteria in different circumstances (*i.e*. applying a different formula for active employees and former employees, or for income distributions and capital distributions) the trustees have no discretion to favour the interests of one beneficiary over another.
4. **EOT trustees**: Each trustee of an EOT must be a Canadian licensed trust company or an individual (natural person) and are to be elected at least every five years by the active employee beneficiaries of the EOT. At least one-third of the trustees must be active employee beneficiaries. Unless elected by the EOT active employee beneficiaries, at least 60 per cent of the trustees must deal at arm's length with each member of a vendor ownership group. Each trustee has an equal vote.
5. **Employee beneficiary special approvals**: More than 50 per cent of the active employee beneficiaries must approve the following:
    a. Any transaction or event or series of transactions or events that causes at least 25 per cent of the active employee beneficiaries to lose their employment and cease to be active employee beneficiaries (unless in connection with a termination for cause); and
    b. Any winding up, amalgamation or merger of a qualifying business (other than with affiliates).
6. **EOT property**: all or substantially all (*i.e*. 90 per cent or more) of the fair market value of the EOT's property is attributable to shares in qualifying businesses controlled by the EOT. A qualifying business is a CCPC that meets certain board representation and control requirements, aimed at ensuring the EOT will operate with a level of independence from the prior controlling shareholder(s), related persons, or affiliates.
7. **Control over business**: An EOT must hold a controlling interest in one or more qualifying businesses. Further, 60 per cent or more of the directors must not be individuals who (together with related persons of affiliates) controlled the business prior to the trust acquiring the shares. Directors must deal at arm's length with the prior controlling shareholder(s), related persons or affiliates.

Takeaways

The exemption of the first $10 million of capital gains will make EOTs an attractive succession alternative for business owners. However, the significant adverse tax consequences to the selling individual(s) or the EOT in the event of a disqualifying event may make accessing the exemption difficult or impractical in some cases.

Although the original EOT proposals imposed significant restraints on the operation of the business after control was acquired by an EOT, including a requirement that all or substantially all of the fair market value of the corporation's assets is attributable to assets used in an active business carried on primarily in Canada, these have largely been removed, significantly increasing the flexibility of operating a business controlled by an EOT.

However, it is not clear if these incentives will be sufficient to counter the fact, unless third party financing is available, that the selling business owners will likely receive the proceeds over a period of many years. Given the limitations on the ability to control, or regain control of, the business after sale, business owners may be reluctant to place their trust in the EOT and its trustees to operate the business so as not to jeopardize its ability to fund the purchase price. Given that the funding the purchase price (or repaying third party purchase financing) will require sustainable and predictable cash flow, not all businesses may be suitable candidates for an EOT.

For additional questions about employee ownership trusts, please reach out to any of the authors or key contacts listed below.

BLG's tax team

Our clients rely on us to provide effective tax advice, innovative planning, efficient tax structures and comprehensive risk assessments in all areas of tax.

[1] The EOT proposals are contained in Bill C-59 - *Fall Economic Statement Implementation Act, 2023*, which received Royal Asset on June 20, 2024.

[2] The election form will need to be filed on or before the trust's filing due date for the taxation years that includes the disposition.

By

Pamela L. Cross, Grace Pereira, Francis Jacob

Expertise

Tax, Private Client, Private Company

BLG | Canada's Law Firm

As the largest, truly full-service Canadian law firm, Borden Ladner Gervais LLP (BLG) delivers practical legal advice for domestic and international clients across more practices and industries than any Canadian firm. With over 800 lawyers, intellectual property agents and other professionals, BLG serves the legal needs of businesses and institutions across Canada and beyond – from M&A and capital markets, to disputes, financing, and trademark & patent registration.

blg.com

BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749

The information contained herein is of a general nature and is not intended to constitute legal advice, a complete statement of the law, or an opinion on any subject. No one should act upon it or refrain from acting without a thorough examination of the law after the facts of a specific situation are considered. You are urged to consult your legal adviser in cases of specific questions or concerns. BLG does not warrant or guarantee the accuracy, currency or completeness of this publication. No part of this publication may be reproduced without prior written permission of Borden Ladner Gervais LLP. If this publication was sent to you by BLG and you do not wish to receive further publications from BLG, you may ask to remove your contact information from our mailing lists by emailing unsubscribe@blg.com or manage your subscription preferences at blg.com/MyPreferences. If you feel you have received this message in error please contact communications@blg.com. BLG's privacy policy for publications may be found at blg.com/en/privacy.

© 2026 Borden Ladner Gervais LLP. Borden Ladner Gervais LLP is an Ontario Limited Liability Partnership.