

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

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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 businesses 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 temporary capital gains exemption on the first \$10 million of capital gains realized on the sale of a business to an EOT.² This incentive would be in effect for the 2024, 2025 and 2026 tax years. The legislation relating to this temporary capital gains exemption has not yet been introduced, so its conditions of application and its interaction with the existing \$1 million capital gains exemption available for qualifying small business corporation shares (if the requirements of that exemption are also met) is not yet clear.

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, remuneration (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 5 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 Canadian-controlled private corporation ("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. **Requirements of business acquisition by EOT:** Shares of the qualifying business can be acquired by the EOT or by a CCPC which is wholly-owned and controlled by the EOT. Immediately before the sale, all or substantially all of the fair market value of the assets of the target corporation must be attributable to assets (other than partnership interests) that are used principally in an active business carried on by the target corporation or a subsidiary that is controlled by the target corporation. At the time of the sale, the vendor must deal at arm's length with the EOT and any purchaser CCPC. At all times after the sale, the vendor must deal at arm's length with the target corporation, the EOT and any purchaser CCPC and must not retain any right or influence that would permit the

vendor (alone or together with related parties or affiliates) to control, directly or indirectly in any manner whatever, the corporation, the EOT or any purchaser CCPC. These requirements are to ensure that only genuine business transfers qualify for the preferential tax treatments discussed above.

8. **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 or 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 temporary exemption of the first \$10 million of capital gains may make EOTs an attractive succession alternative for business owners. 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.

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¹ The EOT proposals are contained in Bill C-59 - *Fall Economic Statement Implementation Act, 2023*, which at the time of writing is in Second Reading. If enacted, EOTs will be available on or after January 1, 2024.

² Announced in the Fall Economic Statement 2023

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