

[Employee Ownership Trusts: An Introduction For Business Owners](#)



As discussed in our [prior article](#) on Employee Ownership Trusts, Canadian business owners [report](#) that finding a buyer is a significant obstacle to succession planning. Protecting employees remains a top priority for business owners. More than half report that they would be more likely to sell their business to their employees if that was a viable option. There are many obstacles to selling a business to its employees. A major hurdle is that employees usually cannot borrow the money to pay the departing owner the value of the business.

Fortunately, [Parliament](#) has proposed tax rules to facilitate the creation and implementation of employee ownership trusts. The legislative support for Employee Ownership Trusts came in [Bill C-59](#), which received royal assent in June of this year. There are many unique features of Employee Ownership Trusts, but to avoid burying the lead, we must highlight the tax incentive. In certain circumstances, a departing owner may be entitled to a \$10 million tax exemption. This incentive came in [Bill C-69](#), which also received royal assent in June.

Watch this space for further articles from us on Employee Ownership Trusts.

What are Employee Ownership Trusts?

Employee Ownership Trusts (“EOTs”) are a vehicle that allow Canadian business owners to transition their businesses into the hands of their employees in a tax-efficient manner. In general, an EOT holds the shares of an operating company in trust, for the benefit of the employees of that company. Despite their novelty in Canada, the UK’s EOT scheme and the US’s Employee Stock Ownership Plan have similar designs.

One of the unique benefits of an EOT, relative to other buyers, is that it can borrow from the underlying business in a tax efficient manner. This may smooth over some of the difficulty financing the sale. Essentially, employees can pay the departing owner the fair market value of the company without having to dip into their personal savings. The departing owner can avoid the need to solicit third-party buyers. Sale to an EOT ensures that the owner’s legacy remains whole and stable. This approach also protects employees, ensuring that they receive the benefit of the value that they create. The departing owner can receive the full fair market value of their business and a remarkable tax incentive.

\$10 Million Incentive: What Business Owners Need to Know Now

An individual may deduct the first \$10 million in capital gains on the sale of a business to an EOT until 2027. This is subject to the following conditions:

- No one else has sought this deduction for the same business.
- Throughout the 24 months before the sale:
 - the transferred shares were only owned by the individual, a related person, or a partnership in which the individual is a member; and
 - over 50% of the fair market value of the corporation's assets were used principally in an active business.
- The individual (or their spouse or common-law partner) had to, at some point in the past, work in the underlying business for at least 24 months.
- Immediately after the qualifying business transfer, at least 75% of the beneficiaries of the EOT must be resident in Canada.

The total deduction amount cannot exceed \$10 million. Where several individuals sell to an EOT, they must share the deduction.

However, if a "disqualifying event" occurs within 24 months, the deduction is "clawed back". A disqualifying event occurs when an EOT loses its status as an EOT, or if less than 50% of the fair market value of the qualifying business' shares is attributable to assets used principally in an active business at the beginning of two consecutive taxation years of the corporation.

Caveat: More deferral than exemption

Although the government frames this \$10 million tax incentive as an exemption, the EOT remains subject to the clawback indefinitely. As such, this incentive is more of a deferral of tax until the EOT ceases to be an EOT. After the first two years, the incentive is an exemption from the departing owner's perspective. The trust, however, remains "on the hook."

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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