Employee Ownership Trusts (EOTs): What Canadian Business Owners Need to Know

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A strong business is built by its founders and by its people. When it's time to sell the business, both founders and employees deserve a future that reflects their contributions. That's why staying informed about new tools and opportunities is essential in today's business landscape.

One of the most important new developments in Canada's business succession landscape is the Employee Ownership Trust—EOTs offer a game-changing way to transition business ownership while protecting your legacy, rewarding your team, and taking advantage of a major new tax incentive.

Clark Wilson is proud to have served as legal counsel on the transition to EOT ownership by Canada's largest EOT, and first 100% EOT-owned business. Whether you're planning your exit, thinking about succession, or just want to stay ahead of the curve, here's what you need to know about the EOT.

What is an EOT?

An EOT allows a business owner to pass on ownership to their employees without the employees having to buy shares directly. Instead, the owner sells their shares to a trust, and the employees become the beneficiaries of that trust.

Here's how it works:

- Ownership is held by a trust, not by individuals.
- The EOT becomes the controlling shareholder.
- All employees are beneficiaries of the trust (though not necessarily to an equal degree)
- Employees do not have to contribute capital or take on personal debt.
- Employees don't vote on the Board, keeping governance professional and strategic.

In short, an EOT transition allows an owner to sell their business at full fair market value without having to find a buyer, and giving maximum control of how the future of the business looks.

Why the EOT matters

1. $10 million tax exemption – a major new benefit for Canadian owners

The first $10 million in capital gains realized on the sale of a business to an EOT is exempt from taxation. This incentive is currently set to sunset at the end of 2026, though we hope and expect that the government will extend this sunset.

This $10 million exemption will be shared among any selling owners, however each seller may claim their own lifetime capital gains exemption in addition to this special EOT exemption.

2. Traditional governance – structured like a business, not a co-op

There are clear, delineated roles in the governance of a business owned by an EOT. The fundamental roles are described here:

> the trustees of the EOT are the shareholders of the business;

> the shareholders appoint the company's Board of Directors, just like any other company;

> the Board of Directors runs the business, just like any other company;

> the management team continues to execute the decisions of the board; and

> the employees do the jobs they have always done—now with the added benefit of ownership (shared profits and/or equity) and increased engagement with the business' success.

Although a sale to an EOT allows a huge amount of control by a departing owner relative to an arm's length sale, there are certain limits to the formal power that can remain in the departing owners hands. The seller can't retain more than:

> 49% of the company shares;

> 40% of the trustee vote; or

> 40% of the directorship of the business.

A departing owner can still be involved in, and have influence over, the strategic direction of the company; these limits are on the legal control of a departing owner. One area that's easy to overlook, however, is how much control a departing owner has in setting up the EOT and the company.

3. A built-in buyer – no need to hunt for a buyer

Selling to an EOT eliminates the need to hunt for a buyer. Furthermore, it allows a sale of the business to the people who know it well; the people who have and will continue to oversee the day-to-day of the business. Going forward, their interests will be even more aligned with the company's success, fostering greater motivation and productivity for long-term value growth.

Selling to an EOT can be a seamless transition that keeps the business in trusted hands and allows the employees to thrive as owners, while the former owner maintains peace of mind knowing their legacy will continue.

4. Protecting legacies – keeping business identity and values intact

It can be unnerving to sell a business to a third party, no matter the price, when it's unclear whether the core aspects of the business will be protected. In many ways, an EOT allows a departing owner to "lock in" their vision for the business.

While selling to an EOT entails giving up legal control, a seller gets the peace of mind that they are passing on the business to the people most familiar with the business: with how things are done and why.

5. Fully leveraged – employees aren't required to fund the buyout themselves

With an EOT, employees don't come up with the capital to purchase the business upfront. Instead, the purchase is financed by the business' cash flow over time (that is, by the ongoing work of the employees).

This may entail both seller financing and third-party financing by a bank. Part of the purchase is financed by a loan from one or more third parties, like a bank: that money is paid to the seller right away. What is left of the debt is owed to the seller from the business to be paid over a period of time.

This means that employees don't have the financial burden of paying out of pocket and instead can pay for the purchase by keeping the business running and growing its value.

While it takes a little longer to get the full amount of the sale price compared to some arms length sales, a vendor still gets the full value of the company along with the many benefits of an EOT (not least of which is that $10 million exemption!).

6. Full fair market value – owners aren't forced to take a discount

As discussed above, a sale to an EOT happens at fair market value, and not at a discounted value. There is flexibility in setting the repayment period, as any gain for tax purposes can be spread over the subsequent 10 years as payments come in.

Where vendor financing is required, a sale to an EOT will not be an immediate exit, however due to the tax exemption, it can be the most lucrative.

7. Canadian sovereignty – ensuring Canadian businesses remain Canadian-owned

Selling to an EOT is an excellent way to ensure Canadian businesses remain Canadian-owned.

An EOT must be Canadian controlled, and as such, a sale to an EOT ensures that ownership does not flow out of the country. Although foreign private equity has its place, sometimes such purchasers don't share the same care for the Canadian business as Canadian owners do.

Still worried? See how the EOT has proven itself in the US/UK context

EOTs are new in Canada, and that means there is some uncertainty about how they will work. However, it is easy to overstate that uncertainty. To bring it into perspective, it's important to look to similar models that are well-established elsewhere:

- In the US, Employee Stock Ownership Plans ("ESOPs") have existed since 1974, and 14.9 million employees in the US are ESOP beneficiaries. Plus, more than 250 new ESOPs are created every year.
- In the UK, EOTs were established in 2014 and their numbers have grown exponentially since, and now more than 1 in 20 business transitions are going into EOTs.

From these successful examples, there are some key takeaways, which indicate that EOT-owned businesses do very well; that is to say, they're simply good business! In particular, UK data shows that EOTs are:

12% more productive	50% more likely to be hiring	25% more likely to see profit growth

US data on their take on their common EOT model show that EOTs are:

300 -400% more likely to retain staff	HALF Half as likely to make pay cuts	50% more likely to see profit growth

And employees of these Us companies:

- have 33% higher median income;
- have 92% higher net wealth; and
- have 4x more access to benefits.

Canada is just getting started, and early adopters will be best positioned to take full advantage.

Ready to take the next step? Let's talk.

EOTs offer Canadian business owners an opportunity to pass on their legacy while rewarding the people who helped build the business. By transitioning ownership to employees, you not only preserve the company's culture and values but also create a more motivated, engaged workforce that shares in the company's success.

If you are ready to retire, sell, or just want a succession plan that puts your employees first: an EOT could be the solution you've been looking for.

So, how can you take part in this opportunity?

Reach out to discuss how you can make the transition to employee ownership smooth, rewarding, and impactful for everyone involved.

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