EMPLOYEE OWNERSHIP TRUST: AN EXIT AND SUCCESSION PLANNING ALTERNATIVE OPTION FOR PRIVATE BUSINESSES

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Owners of private companies seeking an exit often face a dilemma: how to monetize their ownership while protecting their employees and company's legacy. The Employee Ownership Trust (EOT) structure offers a solution that transfers control to a trust rather than a third-party buyer.

With the introduction of EOTs in the 2023 Federal Budget - and subsequent enhancements in 2024 - owners, boards and executives of private businesses now have a new tool for business owners approaching retirement or looking to exit the company while keeping the business in Canadian hands.

Designed to facilitate business continuity and broaden employee participation, EOTs allow a trust to hold a controlling interest in a private company on behalf of its employees. This structure effectively enables employees to participate in the economic success of the business without requiring them to personally finance the purchase of shares.

WHY NOW? THE STRATEGIC CASE FOR EOTs

As a "silver tsunami" of retiring founders approaches[1], many are searching for an exit that preserves their legacy and ensures business continuity. Unlike a sale to private equity or a strategic competitor, an EOT allows a company to remain independent while transitioning ownership to its workforce.

1. Succession and Legacy

EOTs provide a pathway for founders to exit while ensuring the company's mission and culture remain intact. It solves the "governance gap" by establishing a Trust Board to oversee the long-term interests of the employees, while a separate Company Board continues to manage day-to-day operations.

2. Increased Employee Engagement & Productivity

Broad-based ownership is a proven driver of engagement. When employees feel like owners, the alignment between individual effort and firm performance tightens, often leading to improved retention and productivity.

3. Tax Advantages

The EOT framework includes targeted tax incentives designed to encourage adoption, including:

- **Capital Tax Gains Exemption:** The first $10 million in capital gains from a sale to an EOT can be tax-exempt (subject to specific conditions and a 2026 sunset clause).

[1] According to the 2023 Federal Budget, more than 75% of small business owners are planning to retire in the next decade

- **Extended Capital Tax Gains Reserve:** The ability to defer capital gains tax over a 10-year period, instead of the standard five years.
- **Shareholder Loan Exception:** An exception to the usual shareholder loan rules under the *Income Tax Act* (Canada) allows the company to lend funds to the EOT for up to 15 years to finance the share purchase.

MECHANICS OF THE EOT STRUCTURE

Broadly speaking, an EOT is a legal structure where a trust holds shares of a corporation for the benefit of the company's employees. The process typically follows three stages:

1. **Trust Formation:** The owner establishes a trust governed by trustees (often a mix of employees, independent professionals, and the founder).
2. **The Acquisition:** The trust must acquire control (more than 50% of the voting shares and value of the company) of the business. This is usually financed through "vendor take-back" loans or bank debt, repaid over time from the company's profits.
3. **Employee Participation:** Employees do not "buy" shares. Instead, they become beneficiaries of the trust. They benefit through profit-sharing distributions and enhanced job security, though they hold indirect ownership rather than direct voting equity.

WEIGHING THE TRADE-OFFS

While the benefits are substantial, EOTs are not without complexity.

Pros	Cons
✓ **Continuity of Business and Culture:** Ownership stability supports long-term strategy and preserves jobs ✓ **Employee Alignment:** Broad-based participation can reinforce engagement and accountability ✓ **Legacy Preservation:** Founders can exit knowing the business will not be dismantled or resold ✓ **Attractive Tax Treatment:** For qualifying sellers	× **Limited eligibility:** only applies to Canadian-Controlled Private Corporations (CCPC) and only individuals can benefit from the tax incentives × **Cash Flow:** Servicing the debt to buy out the founder can limit reinvestment capital × **Complexity:** Significant legal and valuation costs × **No Direct Equity for Employees:** Employees do not build individual equity stakes, which may limit perceived upside for some roles

WHEN IS AN EOT THE RIGHT FIT?

EOTs tend to work best in specific contexts:

- Founder-led or closely held businesses with no clear internal successor
- Organizations with a significant number of long-term employees who are interested in participating in the ownership and governance of the business
- Stable, cash-generating companies capable of funding the trust acquisition over time
- Owners who want to ensure that ownership is spread broadly among employees, rather than concentrated among a few individuals

They are less suitable for highly leveraged, high-growth, or exit-driven strategies that rely on equity liquidity and frequent ownership change.

EXECUTIVE COMPENSATION CONSIDERATIONS

EOT presents a unique challenge as companies may be limited to offer traditional equity plans – such as Stock Options, Performance Share-Units (PSUs) or Restricted Share Units (RSUs) - to incentivize executives.

Under the current EOT rules, "excluded employees" (those owning more than 10% of the company or certain family members) cannot be beneficiaries. Furthermore, since the Trust must hold a controlling stake, the pool for individual equity grants is effectively reduced.

To remain competitive, some organizations may need to consider synthetic or cash-based incentives:

- **Phantom Equity Plan (cash-denominated incentives):** Executives receive units that track the company's valuation. Payouts are made in cash upon vesting, mimicking the economic experience of a shareholder without actual share issuance.

- **Performance-Linked Cash Long-Term Incentive Plans (LTIPs):** Multi-year cash bonuses tied to long-term EBITDA growth, debt reduction (to clear the EOT loan - "vendor take-back" loans or bank debt).

- **Deferred Compensation Arrangements:** Using retirement vehicles or deferred bonus plans to create attractive incentives that encourage long-term tenure.

KEY TAKEAWAYS FOR BUSINESS OWNERS, BOARDS AND EXECUTIVES

The clock is ticking on the $10 million tax exemption, which is currently slated to be a temporary window until December 31, 2026. For business owners, boards and executives considering an EOT structure, the following steps are critical:

1. **Valuation & Feasibility:** Conduct an independent valuation to ensure the EOT is financially viable without crippling the company’s growth.

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2. **Governance Mapping:** Clearly define the relationship between the Trust Board (the "Owners") and the Company Board (the "Managers").

3. **Incentive Plan Review:** Proactively redesign executive pay. If you lose the "equity story," you must replace it with a "performance story" that is equally lucrative and compelling.

For the right organizations, EOTs can preserve legacy, reinforce culture, and embed employee participation at the heart of ownership. For boards and executives, the challenge lies in navigating the trade-offs - particularly around governance and compensation design - while remaining clear about what this structure enables, and what it deliberately constrains.

This article provides a high-level overview and does not encompass all the nuances associated with various types of private organizations, including instrument-specific features, regulatory limitations, and tax implications. We invite your team to connect with us for personalized guidance.

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