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Considering an employee ownership trust? The clock is ticking…

Kun Li and Lawrence Levin, Toronto

Business succession is a hot topic in Canada. In addition to the usual succession alternatives, employee ownership trusts (EOTs) have emerged as a compelling option for business owners seeking to leave a meaningful legacy while enjoying significant tax benefits.

However, one of the main tax benefits, the $10 million capital gains exemption for qualifying business transfers, is scheduled to expire on December 31, 2026.

In this article, we briefly review the main features of EOTs and identify key questions business owners should consider in assessing whether this alternative may be an effective succession planning tool.

What is an EOT?

An EOT is a vehicle used to facilitate the sale of a privately owned business to its employees. In general terms, an EOT is a Canadian-resident trust established to hold the shares of the business for the employees' benefit. The employees are beneficiaries of the trust, but they don't own shares of the business directly.

Typically, employees do not contribute funds. Instead, the trust finances the purchase using income generated by the business. Where bank financing is possible, the owner(s) may receive a portion of the purchase price at the time of sale. However, in most cases, the EOT structure results in the owner(s) receiving payments over several years, depending on the business's income. EOTs are therefore not suitable for owners who wish to receive all proceeds upfront and are unwilling to assume some risk of nonpayment.

Why consider an EOT?

EOTs offer several advantages over traditional succession methods, including:

- **Employee wealth and engagement:** EOTs give workers a direct stake in the company's performance, which can boost engagement and potentially drive overall business success.

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- **Resilience:** Companies owned by EOTs may be more resilient, experience fewer layoffs during recessions and perform better during recoveries.
- **Community strength:** By keeping ownership local, EOTs may contribute more to their local communities.
- **Economic protection:** EOTs can help protect Canadian businesses from foreign acquisition, preserving local jobs and economic activity.
- **Tax incentives:** An owner may benefit from certain tax incentives, including a temporary tax exemption on up to $10 million in capital gains on a qualifying business transfer to an EOT, which could be worth up to $2.67 million for Ontario residents.

How EOTs work

An EOT is a new type of trust created under the *Income Tax* Act (the Act).[1] Key requirements generally include:

- The trust must be established to hold shares (either directly or indirectly) of a qualifying business that carries on an active business operation, exclusively for the benefit of current, and potentially former, employees. A qualifying business is a Canadian-controlled private corporation that meets certain governance and board representation requirements.[2]
- At least 90% of the fair market value of the trust's property must be attributable to shares of one or more qualifying businesses that the trust controls. This requirement can be satisfied on a "look-through" basis, such as where the trust's sole property consists of shares of a wholly owned holding corporation whose sole asset is shares of a wholly owned subsidiary corporation that is a qualifying business.[3]
- To establish an EOT, there must be a "qualifying business transfer,"[4] which involves the owners transferring at least 50% of the business to the EOT on an arm's-length basis. Other conditions apply, such as restrictions on previous owners retaining control after the transfer and the requirement that most assets be used in active business operations immediately before the transfer.
- The trust must be managed by trustees who meet specific conditions.

Beneficiaries of the EOT

All beneficiaries must be either current employees or former employees of the qualifying business controlled by the EOT. Former employees who were employed by the business before the trust acquired control, however, would not be eligible. The capital and income interests of each beneficiary must be determined equitably, based on criteria such as seniority (i.e., total period and hours of employment service) and compensation (i.e., salary and wages), or a combination thereof.

The EOT may use different formulas for distributing income and capital to current versus former employees. While the distribution formula can exclude employees who have worked for less than 12 months, generally all employees must be beneficiaries. The EOT is designed to benefit all employees, not just key personnel.

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[1] The EOT rules were first announced in the 2023 federal budget and certain amendments have been added to their initial design to facilitate the establishment and use of EOTs in Canada. For more details, see EY Tax Alert 2023 Issue No. 47 and EY Tax Alert 2024 Issue No. 29. "Employee ownership trust" is defined in subsection 248(1) of the Act.
[2] The term "qualifying business" is defined in subsection 248(1) of the Act.
[3] A proposed amendment to the definition of "employee ownership trust" in subsection 248(1) of the Act is intended to make this clearer. The proposed amendment will also allow for indebtedness of a qualifying business to be taken into account when determining if the 90% fair market value test is met.
[4] Defined in subsection 248(1) of the Act.

Governance of the EOT

Trustees play a crucial role in EOT governance. At least one-third must be current employee beneficiaries. The trustees must be elected within the last five years by the current employee beneficiaries or, if any trustee is appointed, at least 60% of all trustees must be dealing at arm's length with the previous owners.

Trustees must have equal votes and must treat all beneficiaries fairly. Each trustee has an equal vote in trust affairs. Major decisions, such as mergers or winding up the business, require approval from more than 50% of the current employee beneficiaries.

Tax incentives of transferring a business to an EOT

$10 million capital gains exemption

The most significant incentive for selling a business to an EOT is the $10 million capital gains exemption, available on a temporary basis for qualifying business transfers.[5]

This exemption is similar to the lifetime capital gains exemption (LCGE), but the key differences are that the $10 million capital gains exemption must be shared among sellers, and the exemption is only available to owners who actively worked in the business for a minimum period. As well, the exemption is currently only available if the qualifying business transfer occurs after 2023 and before 2027.

Sellers cannot benefit from both the $10 million capital gains exemption and the LCGE on the same portion of a taxable capital gain. Under proposed legislation, where a seller is eligible for both the LCGE and the $10 million capital gains exemption, they must first claim the EOT exemption followed by the LCGE.[6]

10-Year capital gains reserve

Another important tax incentive is an extended capital gains reserve period for transfers to an EOT. Sellers can defer tax by recognizing the capital gain over a period of up to 10 years, versus the 5-year maximum in other situations.[7]

This feature is important because, as noted above, the purchase price is generally paid to the seller over time. [8]

Exception to the 21-year deemed disposition rule

Normally, most trusts in Canada are deemed to have disposed of their capital property every 21 years, triggering income tax on any accrued gains, even if the property has not actually been sold.

EOTs are exempt from this 21-year deemed disposition rule;[9] as such, EOTs can hold shares of the qualifying business indefinitely.

Is an EOT worth considering?

An EOT conversion is certainly worth considering for owners looking to transition their business. To assess whether an EOT is the right succession tool to use, important factors to consider include:

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[5] Section 110.61 of the Act.
[6] Proposed subsections 111.1(1) and (2) of the Act.
[7] Subsection 40(1.3) of the Act.
[8] In recognition of the fact it will take an EOT a longer period of time to repay funds borrowed from the qualifying business to purchase the shares, the EOT is allowed to repay the loan over a 15-year period (rather than one year) before the shareholder loan rules will apply to require any unpaid amount of the loan to be included in the EOT's income. This exception, which is provided in subsection 15(2.51) of the Act, is intended to further facilitate business transfers to an EOT.
[9] Definition of "trust" in subsection 108(1) of the Act.

1. **Does transferring the business to an EOT align with the sellers' succession objectives?**
    - Are the sellers motivated by objectives beyond maximizing sale price, such as benefiting employees and the local community, preserving the business's culture and independence, and leaving a long-term legacy?
    - Are the sellers prepared to accept a loss of control? An EOT requires that former owners and non-arm's-length parties control no more than 40% of board of director votes after the transition; as such, former owners cannot continue to control the business once it is transferred to an EOT. This loss of control may be a significant drawback, particularly because the seller's consideration is generally paid over time, and the payment may be dependent on post-transfer business performance.
2. **Is the business eligible for the EOT tax incentives?**
    - EOT conversions are only available to businesses that meet the eligibility criteria. For example, the company must be a CCPC, and a majority of the company's assets must be used in an active business.
3. **Is the business model suitable for an EOT?**
    - Is the business profitable and generating steady, predictable cash flow? Ongoing profitability is essential to fund the payment of the sale proceeds to the vendor.
    - Is the business operationally stable and not overly dependent on the departing owner?
    - Are employees motivated to take on ownership responsibilities, and capable of managing the business prudently over the long term?
4. **Are the tax incentives sufficiently valuable in this situation?**
    - The tax incentives, including the $10 million capital gains exemption, are significant. However, the relative benefit may diminish as the business's overall value increases.
    - Sellers should assess whether the tax savings adequately compensate for other tradeoffs, such as loss of control of the business and deferred receipt of all or a portion of the sale proceeds.
5. **Are the financial risks of an EOT transition acceptable to the sellers?**
    - Are the sellers willing to receive payment of the sale proceeds over an extended period, or accept the risk of delayed or reduced payments if the business underperforms?
    - Is bank financing available?
6. **Is there sufficient time to complete the transaction to benefit from the exemption?**
    - The sunset date of December 31, 2026 for the $10 million capital gains exemption is approaching.
    - While there have been requests to remove the sunset date, there was no mention in the 2025 federal budget, and there is no guarantee of extension.

Conclusion

EOTs present an opportunity for sellers to benefit their communities and create a lasting legacy. While there are clear tax incentives, whether an EOT is right for particular sellers depends on their willingness to accept payment over time and the risk of not being paid in full, as well as a loss of control over the business.

Business owners considering an EOT should seek tax and legal advice promptly to determine both eligibility for the available tax incentives and the suitability of an EOT as a long-term successor to the business.

With the main tax incentive set to expire on December 31, 2026, and given the time required to set up an EOT, sellers considering this option should act quickly to avoid missing out on this opportunity.

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Lucie Champagne, Alan Roth and Candra Anttila, Toronto

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Amended farming loss restriction rule applies: a doctor's farming operation considered a subordinate source of income to her medical practice

Stackhouse v The King, 2025 FCA 175

Luke Tincknell and Selena Ing, Toronto

In this case, the taxpayer was both a medical doctor and a farmer. She had consistently incurred losses in her farming business and deducted them against her income, which included her substantial income earned from her medical practice.

Generally, for income tax purposes, a taxpayer who incurs a loss from carrying on a business may deduct it against their income from another business, property or employment. However, losses incurred in a farming business may be limited by the farming loss restriction rule in subsection 31(1) of the *Income Tax Act* (the Act).

The CRA applied the restriction rule to the taxpayer in respect of two sets of years:

- Her 1997 and 1998 taxation years, which were the subject of an earlier successful appeal to the Tax Court of Canada in 2007
- Her 2014 and 2015 taxation years, which were the years at issue in the 2025 Federal Court of Appeal judgement

The restriction rule was amended in 2013, applicable for taxation years ending after March 20, 2013, and therefore the analysis was different in the 1997 and 1998 appeal compared to the 2014 and 2015 appeal.

Farming loss restriction rule – combination exception before and after	
Pre-2013 amendment to s. 31(1) of the Act	**Post-2013 amendment to s. 31(1) of the Act**
31. (1) Where a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income, for the purposes of sections 3 and 111 the taxpayer's loss, if any, for the year from all farming businesses carried on by the taxpayer shall be deemed to be the total of …	31. (1) If a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income that is a subordinate source of income for the taxpayer, then for the purposes of sections 3 and 111 the taxpayer's loss, if any, for the year from all farming businesses carried on by the taxpayer is deemed to be the total of…
Chief source of income = Farming OR Farming (subordinate or primary) + other source	Chief source of income = Farming OR Farming (cannot be subordinate) + Other source (must be subordinate)

Supreme Court decisions interpreting pre-2013 amendments

Previous Supreme Court of Canada decisions in *Moldowan v The Queen*, [1978] 1 SCR 480 and *The Queen v Craig*, 2012 SCC 43, interpreted the meaning of the combination exception.

In *Moldowan*, the Supreme Court found "chief source" to mean the taxpayer's reasonable expectation of income and ordinary mode and habit of work, which could be analyzed by looking to factors like time spent, capital committed and actual profitability.[10] As such, the Court said the combination exception would apply if a taxpayer's chief source of income included farming so long as farming was primary.

Moldowan was criticized on the basis that it rendered the combination exception pointless because it required farming to be the primary source of income.

In *Craig*, the Supreme Court agreed with the critics and sought to clarify the meaning of the combination exception. The Court stated that if farming and another source of income are each a "significant endeavour," then the restriction rule would not apply.

Practically then, the farming business could incur substantial losses compared to the other source of income, but so long as it was a "significant endeavour" based on non-exhaustive factors such as capital invested, income, time spent, ordinary mode of living, farming history and future intentions, then the farming losses would be deductible and the restriction rule would not apply.

Purpose of the amendments to the restriction rule

The Department of Finance responded by amending subsection 31(1) of the Act to overrule portions of *Craig* and reinstate portions of *Moldowan* in an effort to ensure the system was not being abused by allowing taxpayers to deduct grossly disproportionate farming losses against substantial income from another source simply because they invested considerable time and effort into an obviously unprofitable farming business relative to their main income source.

Stackhouse v The Queen, 2007 TCC 146

During the 1997 and 1998 appeal, the key issue for determining whether the restriction rule applied was whether the taxpayer's chief source of income was either farming or a combination of farming and another source of income.

The Tax Court looked to *Moldowan* for the meaning of "chief source" of income as applied to the combination exception. The Tax Court allowed the appeal and held that the taxpayer's capital, time and labour (relevant economic factors) were focused on the farm, such that the taxpayer satisfied the combination exception — namely, that her chief source of income was the combination of her medical practice and farming business. Accordingly, the restriction rule did not apply.

Stackhouse v The King, 2023 TCC 156

During the 2014 and 2015 taxation years, the taxpayer claimed significant losses stemming from her farming business. The CRA reassessed her by applying the <u>amended</u> restriction rule, which now requires that, for the combination exception to apply (chief source of income = farming + some other subordinate source of income), the farming cannot be "subordinate."

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[10] *Moldowan* at p. 486.

Analysis

The Tax Court's analysis centred on interpreting the new combination exception. In doing so, the Tax Court analyzed the meaning of "chief" and "subordinate." It found that "chief" in subsection 31(1) meant "most important," "principal" or "greatest." Further, it found that the adjective "subordinate" meant "secondary to some other (chief or principal) thing."

Relying once again on the *Moldowan* decision, the Tax Court noted that "[t]he distinguishing features of a 'chief source' are the [Taxpayer's] reasonable expectation of income from either a single source of income or a combination of various sources, and [the Taxpayer's] ordinary mode and habit of work." Relevant factors include time spent, capital committed, and the actual and potential profitability of the source.

Decision

The Tax Court ultimately dismissed the appeal and concluded that farming was the taxpayer's subordinate source of income based on non-exhaustive factors, including:

- The taxpayer's centre of work routine was her medical practice.
- Her farm activities took place before and after normal working hours, whereas she attended to the medical practice during normal working hours and during emergencies.
- Her gross revenue in 2014 and 2015 was disproportionate to her medical practice.
- Despite investing millions of dollars in the farm, it continued to require substantial financial support from the medical practice.
- There was no objective evidence that the farm would become self-sustainable in the future.

Stackhouse v The King, 2025 FCA 175

Analysis

The Federal Court of Appeal was required to determine whether the Tax Court's interpretation of subsection 31(1) of the Act was correct. In doing so, the Federal Court of Appeal confirmed that parts of both *Craig* and *Moldowan* remain relevant to informing the interpretation.

In *Moldowan*, the Supreme Court interpreted the combination test as requiring farming to be the predominant source, while the other source must be subordinate. In *Craig*, the Supreme Court stated that a source must be a significant endeavour on which the taxpayer places significant emphasis to be included as one of the two sources.

Accordingly, based on *Craig* and *Moldowan* informing the amended restriction rule, if a taxpayer has two significant endeavours, then those two sources must be compared to each other to determine which of them is subordinate. If farming is the subordinate source, the restriction rule applies.

Decision

The Federal Court of Appeal rejected the taxpayer's suggestion that, in determining which of the two sources is subordinate, priority should be given to time, attention, energy and capital invested, instead of actual or potential profitability.

The Federal Court of Appeal confirmed that the income-producing history (including revenue and income) and potential of the farming business are both relevant factors when comparing the two sources. Further, the Federal Court of Appeal endorsed the factors that the Tax Court considered in determining the taxpayer's subordinate source of income was her farming business.

Ultimately the appeal was dismissed and the Federal Court of Appeal upheld the application of the restriction rule.

Takeaway

Subsequent to the amendments, in cases where a taxpayer's chief source of income is a combination of farming and another source of income, farming cannot be a "subordinate" source of income. If it is, then the restriction rule will apply to limit the amount of losses from farming that can be deducted from a taxpayer's income.

Despite the above amendments, portions of *Moldowan* and *Craig* remain relevant. Specifically, the combination exception requires that farming not be subordinate to the other source of income (*Moldowan*) (now codified in the amended restriction rule), and also that farming must be a "significant endeavour" (*Craig*).

The taxpayer has sought leave to appeal to the Supreme Court of Canada.

Publications and articles

Tax Alerts – Canada

Tax Alert 2025 No. 53 – Budget 2025 introduces revised transfer pricing rules

Tax Alert 2025 No. 54 – 2025 budget implementation bill no. 1 introduced in House of Commons

Tax Alert 2025 No. 55 – Canada announces new measures for steel imports

Tax Alert 2025 No. 56 – Valuation for Duty Regulations, take two: CBSA invites feedback on revisions to 2023 proposals

Tax Alert 2025 No. 57 – OECD Commentary 2025: Lower risk for remote work — Is it time to rethink your policy?

Tax Alert 2025 No. 58 – Accelerated CCA and other immediate expensing measures

Tax Alert 2025 No. 59 – Information released with respect to measures announced to protect Canada's steel industry

Tax Alert 2026 No. 1 – Reversal of longstanding position with respect to the GST/HST status of trailing commissions

Tax Alert 2026 No. 2 – Initial insights regarding the OECD Side-by-Side administrative guidance on Canadian taxpayers

Tax Alert 2026 No. 3 – Canada provides guidance for the steel derivative goods surtax and relief for certain steel goods

Tax Alert 2026 No. 4 – CBSA issues its 2026 trade compliance verification list update

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The content for the guide is updated as of April 30, 2025.

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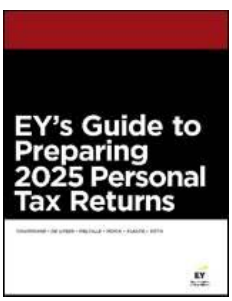

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Editors: Lucie Champagne, Maureen De Lisser, Gael Melville, Caitlin Morin, Yves Plante, Alan Roth

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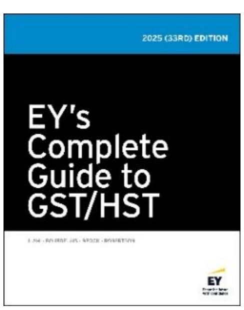

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Editors: Jadys Bourdelais, Thomas Brook, Sania Ilahi and David Douglas Robertson

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