CONSIDERATIONS IN DRAFTING SHAREHOLDER AGREEMENTS

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DRAFTING SHAREHOLDER AGREEMENTS

Shareholder agreements can have many goals. Usually, each agreement seeks to set out rules for the governance of the corporation. At a minimum, this includes the composition of the board of directors but can also include dividend policies, a requirement for unanimous consent in respect of certain decisions and whether and to what extent shareholders will be required to personally finance corporate operations. Most shareholder agreements also deal with exit strategies by providing buy-sell mechanisms that will come into play on the occurrence of specified future events.

Tax considerations will usually figure prominently in framing the buy-sell mechanisms. However, it is sometimes easy to overlook that some buy-sell mechanisms can trigger significant changes in the tax status of the corporation – changes that occur as soon as the agreement is signed, and long before any of the buy-sell provisions are triggered.

This paper will outline some considerations that will often be relevant when framing a shareholder agreement, with emphasis on the tax rules that can have an immediate impact on how the corporation itself is taxed.[1] Many of these tax rules deal with status matters such as corporate control, associated corporation status and affiliated corporation status. Deeming provisions in the *Income Tax* Act (the "**ITA**") can result in a seemingly innocuous provision causing the corporation to become associated with or related to some other corporation. It is important to be aware of these deeming provisions and their potential ramifications.

Like any contract, the provisions in a shareholder agreement are limited only by the imagination and skill of the drafters. Consequently, it is impossible to provide an exhaustive examination of all possible tax ramifications that might arise in any given shareholder agreement. Consequently, this paper will attempt to deal with situations that often arise in practice.

Deeming Provisions

Deeming provisions in the ITA can affect who is considered to control the corporation for income tax purposes. Indeed, some deeming provisions can result in multiple persons being deemed to control the corporation at the same time.

> As a simple example, assume that three unrelated shareholders A, B and C each own one-third of the issued shares of a Canadian-controlled private corporation Opco. The shareholders enter into a shareholder agreement

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1 The paper updates an earlier paper by Alain J. Gaucher and Crystal L. Taylor, "Shareholder Agreements – Tips and Traps", presented at the *2003 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2003), at pages 6:1-40. For further discussion of shareholder agreements, see chapter 11 of Howard J. Kellough and Peter E. McQuillan, *Taxation of Private Corporations and their Shareholders*, 3rd edition (Toronto: Canadian Tax Foundation, 1999).

> pursuant to which each shareholder has the right to buy the shares of any other shareholder who commits a default under the shareholder agreement.

Because of the application of rules that will be discussed later, each one-third shareholder of Opco will be considered to own all the shares of Opco for purposes of determining whether Opco is associated with any other corporation.[2]

> Staying with the facts in the previous example, make the further assumption that shareholder A in fact controls Aco, shareholder B in fact controls Bco and shareholder C in fact controls Cco (all Canadian-controlled private corporations).

Given that each of A, B and C are deemed to simultaneously control Opco, Opco will be associated with each of Aco, Bco and Cco.[3] Because two corporations are associated with each other if each is associated with a common corporation, it follows that each of Aco, Bco and Cco will be associated with each other.[4] This arises solely because of a default clause in a shareholder agreement.

Caveat

This paper concentrates on shareholder agreements and discusses various deeming rules as they apply to shareholder agreements. However, the application of the deeming rules is not limited to shareholder agreements. Indeed, the ITA does not even use the term "shareholder agreement". Application of a deeming rule will depend on the nature of the right created, whether found in a shareholder agreement or in some other document such as the corporate articles or even a power of attorney.

> As an illustration of this, return to the previous example and assume that there is no default clause that triggers association. Instead, assume that shareholder A is single and has no family. Shareholder A decides to appoint shareholder B as A's general power of attorney. The power of attorney is not a springing power of attorney and therefore comes into effect immediately (effectiveness is not dependent on the permanent disability of A).

The holder of a general power of attorney would usually have the ability to vote shares held by the donor of the power of attorney. For purposes of determining associated corporation status, the Canada Revenue Agency (the "**CRA**") will take the position that

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2 ITA section 256(1.4)(a), discussed in more detail *infra*.

3 ITA section 256(1)(b), when read with ITA section 256(1.4)(a).

4 ITA section 256(2). It is possible for Opco (the common corporation) to elect out of the application of this provision for purposes of the small business deduction, but at the cost of having its small business limit reduced to nil.

shareholder B owns the shares held by shareholder A.[5] Given that shareholder B is owns one-third of the shares of Opco and is deemed to own the one-third held by shareholder A, shareholder B is considered to own two-thirds of the shares of Opco. As a result, Opco will be associated with any corporation controlled in fact by shareholder B.

While this paper will discuss various ITA rules in the context of shareholder agreements, this is merely because shareholder agreements must deal with the potential application of the rules. However, the rules can apply in other contexts as well.

CORPORATE STATUS

Corporate control is very significant for purposes of the ITA.

A Canadian-controlled private corporation (a "**CCPC**") enjoys a number of income tax advantages, such as a lower rate of tax on the first $300,000 of active business income. Shareholders of a CCPC can potentially take advantage of the $500,000 capital gains exemption when selling shares of the CCPC. In order to maintain status as a CCPC, however, a corporation must not be controlled (at law or in fact) by any combination of public corporations and non-residents. If a public corporation or a non-resident is involved in a corporation, careful attention must be paid to ensure that the corporation does not lose CCPC status.

Control issues affect much more than CCPC status. Control also comes into play in making the following income tax determinations.

1. Whether a corporation is related to another person.[6] For example, transactions between related persons are deemed to occur at fair market value.[7]

2. Whether a corporation is affiliated with another person.[8] If a loss is triggered on a sale to an affiliated person, the seller may be unable to claim the loss.[9]

3. Whether a corporation is associated with another corporation.[10] Associated

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5 CRA Technical Interpretations 9623675 (October 17, 1996), 9726535 (November 26, 1997) and 9814370 (June 12, 1998). However, contrast the approach of the Tax Court of Canada in *Ferronnex Inc. et al* [1991] 1 CTC 2330. In paragraphs 62 and 63, the court seems to take the position that the deeming rule in section 251(5)(b) of the ITA did not apply to a power of attorney because the power of attorney is not a contractual right (the donor of the power can withdraw the power at any time).

6 ITA section 251.

7 ITA section 69.

8 ITA section 251.1.

9 ITA 40(3.4) to (3.6), among other provisions.

10 ITA section 256.

corporations must share the $300,000 "small business limit".

Before drafting a shareholder agreement, it is important to think about whether the agreement could potentially affect any of the above issues. This requires looking at the parties to the agreement. If a shareholder is unrelated to the corporation, will the agreement change that status? If a shareholder holds a significant shareholding in another unassociated, unaffiliated or unrelated corporation, will the agreement cause the corporation to become associated, affiliated or related to that other corporation?

De Jure Control

In the ITA, a simple reference to "control" means *de jure* control. In general, *de jure* control means ownership of a majority (more than 50%) of the voting shares of the corporation. Under this general understanding, the person with *de jure* control has enough shares to control who is elected to the board of directors.

However, this general definition of *de jure* control assumes a "normal" corporation in which the directors perform the normal functions of directors. If the corporate articles remove those normal director functions from the directors – as is now possible under the BCA – this general definition of *de jure* control might no longer apply. The question then centers on identifying the group with actual legal control of the corporation. This does not involve "control in fact" situations, because the inquiry will be restricted to an examination of the corporate constitutional documents. However, this does not mean that the inquiry will stop at a simple examination of the central securities register to determine who has a majority of the voting shares. Courts will look at who has control of the corporation in light of the corporate constitution.

As an example, consider the Supreme Court of Canada decision in *Imperial General Properties Ltd.*[11] Holdco owned 90 of the 100 common voting shares of Imperial General. An unrelated individual (G) owned the remaining 10 common voting shares. G and G's wife also owned 80 voting preference shares of Imperial General. As a result, Holdco held exactly 50% of the voting shares of Imperial General The constitution of Imperial General provided that Imperial General could be wound up by a resolution approved by 50% of all voting shares (no need for a majority). On a winding-up, the preference shares (owned by Mr. and Mrs. G) were entitled to recover only a nominal amount. The common shareholders were entitled to any remaining surplus, which meant that Holdco would receive 90% of the corporate value on winding up. The Supreme Court decided that Holdco controlled Imperial General because Holdco had enough voting shares (50%) to cause a winding-up of Imperial General and would receive 90% of the corporate value in that event. In the words of the majority of the court,

> […] the court is not limited to a highly technical and narrow interpretation of the legal rights attached to the shares of a corporation. Neither is the court constrained to examine those rights in the context only of their immediate

[11] *Imperial General Properties Ltd.*, [1985] 2 CTC 299 (SCC).

> application in a corporate meeting. It has long been said that these rights must be assessed in their impact "over the long run".[12]

In jurisdictions that give statutory recognition to unanimous shareholder agreements, a unanimous shareholder agreement is generally seen as one of the corporate constitutional documents. Consequently, provisions in a unanimous shareholder agreement will have the same status as the corporate articles in determining who has legal control of a corporation.[13] The principles set out in the above cases would have to be reviewed if the unanimous shareholder agreement contains any unusual provisions that could affect the larger picture of corporate control.

I will use the term **USA** to refer exclusively to a unanimous shareholder agreement that is statutorily recognized as a constitutional document of the corporation. The term will not include a mere shareholder agreement that is signed by all corporate shareholders but that is not recognized by the governing statute as a constitutional document.

Given that the BCA does not give statutory recognition to unanimous shareholder agreements, shareholder agreement provisions should not be relevant in determining who has *de jure* control of a BCA corporation. This should be the case even if all shareholders of the BCA corporation are signatories to the agreement. From a *de jure* control perspective, therefore, it is generally preferable to use standard corporate articles and place special provisions in the shareholder agreement. The non-USA shareholder agreement could require that certain shareholders approve certain acts of the directors, for example, without affecting *de jure* control. However, the situation would change dramatically if the corporation were to continue into another jurisdiction that considered a unanimous shareholder agreement as part of the corporate constitution. This is something to consider carefully before changing corporate jurisdictions.

De jure control is important in determining whether a person has acquired control of a corporation for purposes of the loss streaming rules[14] and the deemed fiscal year-end rules.[15] Consequently, these rules could be triggered by an amendment to corporate articles or the conclusion of a statutorily-recognized USA that affects the *de jure* control principles discussed above.

Factual Control

Given that *de jure* control considers only constitutional corporate documents, *de jure* control is subject to artful manipulation. As a result, many ITA provisions expand the

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12 *Imperial General Properties Ltd.*, [1985] 2 CTC 299 (SCC), at paragraph 11.

13 See *Duha Printers (Western) Ltd.*, [1988] SCR 795.

14 ITA section 111.

15 ITA section 249(4).

concept of control to include control in fact. Whenever the ITA uses the long-winded phrase "controlled directly or indirectly in any manner whatsoever", the ITA is expanding control to include factual control.[16]

Factual control is significant for a number of ITA provisions, including the following.

1. CCPC status.

2. Associated corporation status.

3. Affiliated person status.

The factual control concept eliminates the distinction between USA-type constitutional shareholder agreements and simple non-USA shareholder agreements. Any provision in any shareholder agreement could potentially have an impact on factual control. Indeed, factual control can be affected by factors that do not even appear in a shareholder agreement.

Factual control is any direct or indirect influence that, *if exercised*, would result in factual control of a corporation. Consequently, a person who is in a position to exercise factual control has factual control (even if the person does not actually exercise the influence in question). This, an overbearing non-shareholder father could have factual control over the corporation of a dominated son. A major creditor or supplier could have factual control of a corporation that was vulnerable to being unduly influenced by that supplier or creditor.

While factual control can go well beyond the provisions of a shareholder agreement, factual control issues must be carefully examined if a shareholder agreement contains the following types of provisions.

1. A provision that provides a shareholder or director with a casting vote (a vote that breaks a tie).

2. A provision that gives a person the ability to change the board of directors.

3. A provision that gives a person the right to require that certain types of corporate actions be taken.

4. A provision that gives a person a veto over certain corporate actions (although it might be argued that a veto is a purely negative form of control and does not enable the person to dictate what the corporation shall do).

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[16] ITA 256(5.1). One could get the mistaken impression that the phrase was simply expanding the *de jure* control concept to include legal control exercised through several layers of corporate vehicles. However, legal control exercised through multiple corporate layers is still legal control even without the "directly or indirectly" language. Given that the phrase is statutorily defined, it would have been more elegant to use a shorter phrase such as "controlled in law or in fact", but the ITA has never been strong on brevity.

5. A provision that enables a person to hold a hammer over the corporation's head, such as an ability to force the termination of the corporation or other drastic and unpleasant consequences.

Deemed Control

De jure control and factual control are based on a person actually having control (albeit different types of control) of a corporation. In drafting a shareholder agreement, however, one must also be wary of running afoul of deemed control rules – rules that deem someone to have control when in fact the person does not have control.

Deemed control can arise through the granting of options and rights. Two very similar deemed control rules apply.

1. The rule in section 251 applies to determine whether a corporation is related to another person and for the purpose of determining whether a corporation is a CCPC.[17]

2. The rule in section 256 applies to determine whether a corporation is associated with another corporation.[18]

The section 251 rule (related person and CCPC status) is broader than the section 256 (associated corporation rule). For the moment, however, this paper shall consider the elements that are common to both deemed control rules.

Both the related person/CCPC status and associated corporation rules can apply in the following situations.

1. If a shareholder agreement gives a person a right to acquire shares or to control the voting rights attached to shares. In this case, the person is deemed to own the shares in question and related person, CCPC and associated corporation status rules apply on the basis of both actual share ownership and the deemed share ownership.

2. If a shareholder agreement gives a person a right to cause a corporation to redeem, acquire or cancel shares owned by other shareholders. In this case, the shares in question are deemed to have been redeemed, acquired or cancelled by the corporation and related person, CCPC and associated corporation status rules apply on the basis of both actual share ownership and the deemed share ownership after the deemed redemption, acquisition or cancellation.

An exception applies in both situations if the right is exercisable only on the death, bankruptcy or permanent disability of an individual.

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[17] ITA section 251(5)(b).

[18] ITA section 256(1.4).

The above deeming rules are very broad. The right in question does not have to be immediately exercisable. Even equitable, contingent and future rights are potentially caught.

Some Rules of Thumb

The deeming rules will not always be of concern. Before examining the deeming rules in more detail, the following rules of thumb provide some useful guidelines as to situations in which the deeming rules might or might not require careful examination.

1. If no shareholder holds shares (including rights to acquire shares) in another corporation, there should not be any concern about the deeming rules triggering associated corporation status.

   (a) However, what if a shareholder subsequently acquires shares in another corporation? Should the shareholder agreement include a duty to receive permission from the other shareholders before acquiring an interest in another corporation if the acquisition of that interest would cause associated corporation status to arise?

   (b) Even if no shareholder holds shares in another corporation, provisions in the shareholder agreement could still cause the corporation to be related to or affiliated with another corporation.

      (i) Related corporation status may be relevant, for example, if a shareholder's spouse owns shares in another corporation.

      (ii) Even if related or affiliated status does not have negative income tax implications at the moment, it might in the future. This can be difficult to assess.

      (iii) How far does one go in assessing the risk of related or affiliated corporation status? What if a shareholder's sibling has an interest in another corporation that will likely have business dealings with the corporation in question?

2. If a shareholder holds shares in another corporation and neither corporation carries on an active business, association would normally be relevant only for purposes of the capital tax on large corporations. While the combined capital of both corporations may be below the capital tax threshold at the moment, is there a possibility that capital of either corporation could increase significantly?

3. If a shareholder holds shares in another corporation and both corporations carry on an active business, associated corporation status will result in a sharing of the small business limit if aggregate active business income exceeds the small business threshold.

   (a) If aggregate active business income does not currently exceed the threshold, it could in the future. Should the shareholder agreement anticipate this possibility by setting out rules for sharing of the small business limit if aggregate income increases beyond the limit?

(b) Associated corporation status could have large corporations tax implications.

4. If a shareholder holds shares with siblings in family corporations that carry on an active business, careful consideration will have to be given to the deeming rules.

5. If a shareholder holds shares in another corporation and only one of the two corporations carries on an active business, associated corporation status could still have an impact. If the other corporation has substantial capital, association could reduce or eliminate the small business deduction for the first corporation.[19] As well, associated status could have an impact on large corporation tax liability.

6. If all shareholders are resident in Canada and no shareholder is a public corporation, the application of the deeming rules should not result in the corporation losing status as a CCPC. This assumes that there are no factual control issues.

7. If a shareholder is a non-resident or a public corporation and there is a desire to maintain CCPC status, careful consideration will have to be given to the deeming rules as well as factual control considerations.

The above are just rules of thumb and should be treated as such. They do not cover all possible scenarios that might arise in the context of a shareholder agreement.

Application of the Deemed Control Rules

The CRA takes the position that the following rights will trigger application of the above deeming rules. These positions are taken from technical interpretations that dealt with one of the above deeming rules. Given that the two rules have near-identical wording, however, it is safe to assume that CRA positions in respect of one deeming rule will also apply to the other deeming rule.

1. A shareholder agreement often provides that a non-defaulting shareholder has the right to acquire shares of a shareholder who commits a default under the agreement. The nature of a default will vary from agreement to agreement, but could include actions such as pledging shares as security or allowing shares to be seized by a creditor. This type of default clause will trigger the deeming rules.[20]

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[19] ITA section 256(5.1).

[20] CRA Technical Interpretation 9033975 (March 19, 1992). For another example of a default that involved failure to attend shareholder meetings, see CRA Technical Interpretation 9230905 (February 5, 1993).

(a) Given that it is possible for any one or more shareholders to commit a default, each shareholder potentially has the right to acquire all the shares of the corporation. As a result, application of the deeming rule results in each shareholder being deemed to own all the shares of the corporation (whether or not any shareholder ever actually commits a default).

(b) If it is important to avoid application of the deeming rules, another type of default remedy will have to be employed.

2. Shareholder A holds Class NV non-voting shares of corporation X. Shareholder A has the option of converting any number of the non-voting shares into an equal number of Class V voting shares on the occurrence of specified future events that might or might not occur. If shareholder A converts any of the Class NV shares into Class V shares, shareholder B may then convert a proportionate number of B's Class NV non-voting shares into an equal number of Class V voting shares and shareholder A must offer to acquire all the Class V voting shares at a price based on an independent valuation. In this situation, the CRA had the following two comments.[21]

(a) Shareholder A would be related to corporation X on the basis that the two sets of conversion rights were independent. If shareholder A converted all A's non-voting shares into voting shares but shareholder B did not exercise its conversion right, shareholder A would own more than 50% of the voting shares of corporation X. It was irrelevant that shareholder A would acquire control only if shareholder B did not also exercise B's conversion right. The technical interpretation did not go on to address whether shareholder B would also be deemed to control corporation X if shareholder B could end up with more than 50% of the voting shares after conversion of its non-voting shares into voting shares. If this were the case, however, it would presumably follow and corporation X would be deemed to be controlled by shareholder A and would also be deemed to be controlled by shareholder B. While it might be illogical to have a corporation controlled by two separate shareholders at the same time, deeming rules apply independently and do not need to be logical.

(b) The CRA went on to point out that the deeming rules would not apply to shareholder A's obligation to offer to purchase the voting shares held by other shareholders, provided that the other shareholders were not required to accept the offer. This is correct, because an obligation to make a purchase offer is not a right to buy shares.

3. If non-voting shares acquire voting rights on the occurrence of a possible future event, the non-voting shareholder will be considered to own voting shares.[22] In

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21 CRA Technical Interpretation 9421285 (February 8, 1995).

22 CRA Technical Interpretation October 1991-145 (October, 1991). For another example of non-

> the situation under consideration, a public corporation indirectly held 1.5 million non-voting preferred shares in Aco. If Aco missed paying two consecutive annual dividends on the preferred shares, the preferred shares would be entitled to one vote per share. Given that only 500,000 common shares were issued, this meant that the public corporation had deemed control of Aco. As a result, Aco was not a CCPC (even during the time that Aco was meeting its dividend obligations). The conferral of voting rights on non-voting shares as a result of some corporate default is not an uncommon situation. If avoidance of the deeming rules is important, however, it would be important to limit the rights of the non-voting shareholder.

While the deeming rules are very broad, they are not all-encompassing. For example, they do not apply if the corporation (as opposed to another shareholder) has the right to acquire the shares in question. Of course, this assumes that no one shareholder or shareholder group has the right to cause the corporation to trigger its purchase right (in other words, the decision to exercise the purchase right is made by the corporate directors). This can be a useful technique if there is a need to provide for a buy-sell event but the deeming rules would apply if a shareholder had a right to buy shares. Of course, a corporate purchase will trigger deemed dividends for the selling shareholder rather than capital gains.

In contrast, the CRA believes that the deeming rules will apply if there is provision for the automatic redemption of shares by a corporation on the occurrence of a specific event and a person is in a position to cause that event to occur.[23] In that event, the shares in question will be considered to have been redeemed.

The deeming rules probably do not apply in the case of standard “tag-along” and “drag-along” rights in a shareholder agreement. In a “tag-along” provision, the majority shareholder is precluded from selling shares unless the purchaser agrees to offer to buy the shares of the minority shareholders on the same terms. In a “drag-along” provision, the minority shareholders must agree to sell their shares on the same terms as the majority shareholder if the majority shareholder sells his shares to a third party who also wants to buy the shares of the minority shareholders. Neither type of provision gives one shareholder the right to acquire shares of another shareholder, as any sale is typically between the third-party purchaser and the minority shareholders.

In contrast to a drag-along provision, assume that a corporation has two 50% shareholders and shareholder A has the right to acquire the shares of shareholder B if

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voting shares that acquire voting rights on specified events, see CRA Technical Interpretation 9230905 (February 5, 1993). However, conversion of non-voting shares into voting shares should be contrasted with separate vote provisions in corporate law statutes. These provisions provide that holders of non-voting shares have the right to vote as a separate class of shares in respect of certain fundamental changes that would affect that class of shares differently from other classes of shares. Given that this special voting right is exercisable only in respect of specific matters and not generally (i.e. not for the election of directors), that special voting right would not normally trigger application of the deeming rules.

[23] CRA Technical Interpretation 9805705 (June 18, 1998).

required for the purpose of being able to tender all the corporate shares to a third-party purchaser who wanted to acquire 100% of the corporation. In this case, the deeming rules likely would apply because shareholder A has a contingent right to acquire the shares of shareholder B. The typical "drag-along" provision accomplishes the same result (B is not able to prevent A from selling A's shares by B refusing to sell B's shares) without triggering application of the deeming rules. As this example illustrates, the same objective can often be accomplished in two different ways, one of which triggers the deeming rules and one of which does not.

Specific exceptions to the deeming rules also exist. Some are administrative, while others are statutory.

Administrative Exception: Rights of First Refusal and Shotgun Provisions

Shareholder agreements often include right of first refusal ("**RFR**") or "shotgun" provisions. A RFR provision typically provides that a shareholder cannot sell shares to a non-shareholder unless the seller gives the other shareholders the first chance to buy the shares on those specific terms. In a shotgun provision, shareholder X can make an offer to buy the shares of shareholder Y and force Y to elect either to accept that offer or instead buy the shares of shareholder X on the same terms. Both RFR and shotgun provisions arguably confer contingent rights to acquire shares, which should trigger the above deeming rules. However, the CRA has a long-standing published administrative position that the deeming rules do not apply to simple RFR and shotgun clauses.[24]

Other Administrative Exceptions

The CRA has also taken the administrative position that the deeming rules do not apply to the following types of rights.

1. A put arrangement, in which shareholder X can force shareholder Y to acquire the shares owned by shareholder X.[25] Presumably, this is because shareholder Y has no control over when his duty to acquire the shares of shareholder X might arise. Shareholder Y has no "right" to acquire any shares until such time as shareholder X elects to trigger the put.

2. The deemed ownership rules do not apply merely because existing shareholders have a pre-emptive right to subscribe for a proportionate amount of all shares that

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24 See *Interpretation Bulletin* IT-419R2 (paragraph 17) and *Interpretation Bulletin* IT-64R4 (paragraph 37). IT-419R formerly set out the CRA's justification for this policy. The justification (which always seemed a strange exercise in semantics) has been removed from IT-419R2, but the policy still stands. Presumably, the CRA thought that the exercise in semantics might give rise to requests for extension of the policy. CRA has always refused to extend the policy beyond RFR and shotgun provisions.

25 CRA Technical Interpretation 900351 (April 30, 1990).

a corporation might issue in future (an anti-dilution provision).[26] While statutory pre-emptive rights applied to British Columbia corporations incorporated prior to enactment of the new BCA, British Columbia corporations incorporated after enactment of the BCA have to specifically include pre-emptive rights in their articles or in a shareholder agreement if those rights are desired.

3. The deemed ownership rules do not apply if a shareholder agreement merely obliges a shareholder to offer to acquire shares in certain circumstances, provided that the other shareholders are not obliged to sell.[27] In this case, there is merely the obligation to make an offer and no right to acquire.

Statutory Exceptions: Death, Bankruptcy or Permanent Disability

As noted earlier, the deeming rules do not apply if the right in question is exercisable only on the death, bankruptcy or permanent disability of an individual. These are important exceptions, as buy-sell provisions are often triggered on death, bankruptcy or permanent disability. Even if the buy-sell arrangement does not qualify as a RFR or shotgun provision, it will not trigger application of the deeming rules if the buy-sell is triggered only by death, bankruptcy or permanent disability.

The Death Exception

Death of an individual is the most common trigger for a buy-sell provision.

Prior to July 14, 1990, the contingent on death exception was worded differently. Under this old wording, the deeming rule could be avoided by a “warm body” clause that made the buy-sell obligation contingent on the death of a named person who was likely to expire in the near term. Under the pre-1990 wording, the exception continued to apply even after the death in question because the right had originally been contingent on a death. This is no longer the case as of July 14, 1990. Under the current wording, the exception ceases to apply once the death occurs. Any shareholder agreements drafted during the days of the “warm body” clause should be reviewed.

Even though “warm body” clauses no longer protect past the death of the warm body, it is still true that the death in question does not have to be the death of a direct shareholder. For example, take an agreement between two holding corporations, Holdco NR and Holdco C. A non-resident of Canada controls Holdco NR whereas Mr. C (the sole shareholder of Holdco C) is a Canadian-resident individual. Each of Holdco NR and Holdco C hold 50% of the shares of a Canadian operating corporation (Opco) and neither Holdco has *de* jure or factual control of Opco. A shareholder agreement provides that Holdco NR must acquire the Opco shares held by Holdco C on the death of Mr. C. Since the buy-sell obligation is contingent on the death of an individual (Mr. C), the deeming rules do not apply during the lifetime of Mr. C (even though Mr. C is not a direct

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[26] CRA Technical Interpretation 900285 (May 28, 1990).

[27] CRA Technical Interpretation 9421285 (February 8, 1995).

shareholder of Opco) and Opco will continue to be a CCPC.

While the death exception is important, it does not solve all problems. In the preceding example, the deeming rules will apply on the death of Mr. C (because the buy-sell provision will no longer be contingent as of that event). Accordingly, Opco will cease to be a CCPC as of Mr. C's death. If Mr. C dies two days before the end of a taxation year, Opco will not have been a CCPC throughout that taxation year and will lose the ability to claim the small business deduction for that entire year. This is because the deeming rule governs CCPC status but does not apply for purposes of the deemed year-end rules that apply on an acquisition of *de jure* control. If one makes the buy-sell obligation operative only as of the start of the fiscal year that commences after the death of Mr. C, this will still not help because the deeming rule will apply as of the date of death of Mr. C. Accordingly, Opco would have to forego the small business deduction and possibly have a short year-end a few weeks later when the share transaction closes and Holdco NR acquires *de jure* control. Perhaps this situation could be avoided by making the buy-sell provision apply automatically on the death of Mr. C.

The "contingent on death" exception applies only if the contingency is the death of an individual. For this purpose, death has its usual meaning. If the buy-sell provisions operate on the basis of an extended meaning of death, the exception might not be available. For example, a clause might state that a shareholder is presumed dead for purposes of the buy-sell provision if the shareholder cannot be located for a certain period of time. While this type of clause is useful in a springing power of attorney, it may not be a good idea in a shareholder buy-sell provision because the buy-sell clause will then potentially become operative on some event other than death, bankruptcy or permanent disability.

The death in question has to be the death of an individual. Making the buy-sell provision contingent on the dissolution of a corporation does not qualify, even though a corporate dissolution can be characterized as a corporate "death".

The Bankruptcy Exception

As noted earlier, the deeming rules will apply if a non-defaulting shareholder has the right to buy the shares of a defaulting shareholder.[28] However, the deeming rules will not apply if the default that triggers the option is the bankruptcy of an individual.

The deeming rules do not define what is meant by "bankruptcy". Presumably, "bankruptcy" means bankruptcy as defined in the *Bankruptcy and Insolvency Act*.

If the buy-sell provision is contingent on bankruptcy and it is important to avoid the deeming rules, the shareholder agreement should make the buy-sell operate on bankruptcy and not on some event short of bankruptcy. If the buy-sell is triggered by mere insolvency or by a shareholder becoming liable under a judgement for a specified sum, the exception to the deeming rules will not apply.

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[28] See CRA Technical Interpretation 9033975 (March 19, 1992).

As in the case of death, the bankruptcy in question must be the bankruptcy of an individual. If the buy-sell is triggered by the bankruptcy of a shareholder that is a holding corporation, the exception will not apply. In contrast, the exception will apply if holding corporation A has the right to acquire shares held by holding corporation B on the bankruptcy of the individual who holds all the shares of holding corporation B.

The Permanent Disability Exception

The permanent disability exception is very problematic, because the exception contains no statutory definition of "permanent disability".

A prime objective of most shareholder agreements is certainty. Therefore, there will often be a strong desire to define when the buy-sell provision operates in the case of disability. For example, the provision might kick in if the shareholder is unable to work for 6 consecutive months. However, a 7-month disability is not necessarily a "permanent" one. Indeed, a 1990 technical interpretation takes the position that the "permanent disability" exception would not apply to a buy-sell provision that operated after a shareholder was unable to perform corporate duties for 1 year.[29] The interpretation indicates that the CRA takes a narrow view of what constitutes a permanent disability,

> The term "permanent disability" is not defined in the Act and, therefore, in accordance with the "modern rule" for the construction of statutes as expressed by E.A. Dreidger in his book "Construction of Statutes", 2nd ed., (1983) and referred to by Estey J. in Stubart Investments Limited v. Her Majesty the Queen, [[1984] C.T.C. 294] (S.C.C.) 84 DTC 6305 at page 6323 these words "are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament". The ordinary sense of the words "permanent" and "permanent disability" have been commented on as follows:
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> The Oxford English Dictionary, Second edition, 1989, defines "permanent" to mean, inter alia:
>
> > "continuing or designed to continue indefinitely without change; abiding, lasting, enduring, persistent. Opposed to temporary".
>
> Webster's Ninth New Collegiate Dictionary, 1987, defines the same term to mean, inter alia:
>
> > "continuing or enduring without fundamental or

[29] CRA Technical Interpretation 5-9404 (April 20, 1990).

> marked change”.

In addition, Black's law Dictionary, fifth edition, 1979, defines “permanent disability” to mean, inter alia:

> “Incapacity forever from returning to work formerly performed before accident, though this incapacity may be either total or partial.”
>
> “... one which will remain substantially the same during remainder of workers' compensation claimant's life ...”.

It is also important to note that a tax credit for mental or physical impairment (disability tax credit) is available, pursuant to subsection 118.3(1) of the Act, to any individual who has a “severe and prolonged mental or physical impairment”.

Paragraph 118.4(1)(a) provides, inter alia, that for purposes of this disability tax credit, “a person shall be considered to have a severe and prolonged impairment only if by reason thereof he is markedly restricted in his activities of daily living and the impairment has lasted or can reasonably be expected to last for a continuous period of at least 12 months.”

The fact that Parliament chose the term “permanent disability” for purposes of paragraphs 256(1.4)(a) and (b), and not “severe and prolonged mental or physical impairment” as outlined above, would indicate, in our view, an intent on their part to target the exceptions therein to impairments which are expected to last for continuous periods that well exceed the period provided in paragraph 118.4(1)(a) of the Act. This intent is also evident from the framework in which the reference to “permanent disability” is situated within the particular provisions of the law as cited earlier, i.e. death, bankruptcy or permanent disability.

The intent of Parliament as discussed above, along with the definition of “permanent” and “permanent disability” as described above, would all indicate, in our view, that the exceptions as contemplated in subsection 256(1.4) of the Act, target events, the results of which would be, lifelong.

As such, it is our view that a permanent disability for purposes of paragraphs 256(1.4)(a) and (b) would involve a disability which has incapacitated the individual from

> performing functions formerly performed before the event which has caused the disability and there is no reason to believe that such incapacity will not continue throughout the lifetime of the person. Accordingly, in our view the definition of "permanent disability" provided in the above-referenced shareholders agreement would not fall within the exception found in paragraph 256(1.4)(a) of the Act.

While it would be convenient to define disability for purposes of shareholder buy-sell provisions, the concept will have to be left vague if it is important to rely on the "permanent disability" exception to the deeming rules.

An alternative approach might be to dispense with shareholder buy-sell rights on disability and provide instead that the corporation has a right to buy the shares of a disabled shareholder. As long as no single shareholder has the right to cause the corporation to exercise that right (the corporate decision is simply a decision made by the corporate board of directors), one might be able to sidestep the deeming rules altogether. This tactic could also be useful in the case of the death and bankruptcy exceptions if there is a desire to use an extended definition of death or bankruptcy.

As noted at the beginning of this paper, the CRA takes the position that powers of attorney can also cause application of the deeming rules.[30] Assume that a son has power of attorney over his father's assets. Usually, the power of attorney would give the son the ability to vote his father's shares. If the power of attorney is not contingent on permanent disability, the CRA will consider that the son is deemed to own the shares owned by the father. This could cause the son's business corporation to become associated with the father's business corporation, even if neither father nor son actually holds shares in the other's corporation. This can be a significant issue. Even powers of attorney that are contingent on permanent disability will often have an extended definition of what constitutes disability. For example, the son might want to be able to rely on the power of attorney if his father were missing (as in the case of an accident in which the body could not be found). One solution here might be to prohibit the attorney from voting shares so that there is no right to control voting shares. However, that assumes that there is at least one other director in office or that an alternate director has been appointed (so that there is no need to elect a replacement director for the missing father).

STRUCTURING BUY-SELL ARRANGEMENTS

Assuming that one has avoided triggering any adverse changes in the income tax status of the corporation, how does one structure the buy-sell arrangement?

Given that buy-sell arrangements are most frequently triggered by the death of a shareholder, this paper will examine considerations that are relevant to a buy-sell arrangement on death. In order to keep the discussion manageable, the paper will assume

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[30] See *supra*, note 5.

that all shareholders are individuals.

A buy-sell arrangement will have very different income tax consequences, depending on whether the transaction is effected by a corporate repurchase of issued shares or a criss-cross purchase among the shareholders.

In a corporate repurchase, corporate funds can be used to effect the purchase. This means that the surviving shareholders do not have to come up with private financing to effect the purchase. However, it also means that the surviving shareholders do not get an increased tax cost for their shares (the number of issued shares is simply reduced). The estate of the deceased, meanwhile, receives a deemed dividend on the corporate repurchase. While the estate can likely use the deemed dividend to trigger a capital loss that can be offset against any capital gain realized on the death of the deceased, the tax rate on a deemed dividend is higher than the tax rate on a capital gain.

In a criss-cross purchase, the surviving shareholders get an increased tax cost for the shares purchased from the estate of the deceased shareholder. While this is an advantage, the surviving shareholders must finance the acquisition at the shareholder level. The estate will realize a capital gain and pay tax at a maximum 22% rate and might also be able to take advantage of capital gains exemptions.

When drafting a shareholder agreement, it will often be impossible to know which type of buy-out structure will most adequately meet the needs of the surviving shareholders and the estate. For example, the capital gains exemption might be repealed prior to the death of the first shareholder or the shareholder might die at a time when the shares of the corporation do not qualify for the exemption. The life insurance that was acquired to fund the buy-sell back when the shareholder agreement was signed might be inadequate in light of the unexpected growth in the value of the corporation. The rate scheme currently in effect (in which dividends are taxed at a higher rate than capital gains) might no longer apply or even be reversed at the time of death. Consequently, constructing a buy-out structure today that will provide optimal tax benefits at an unspecified point in the future is like shooting at a moving target over the hill in the dark. It might not be wise to make the structure too immobile.

The recent approach to buy-sell arrangements is to build flexibility into the structure so that shareholders can best take advantage of whatever tax advantages might be available. However, this gives rise to a conflict. While flexibility is desirable from a tax perspective, certainty is also an important goal of the shareholder agreement. The shareholders want an enforceable contract that can be relied upon if and when necessary. No shareholder wants to be stuck with a mere agreement to agree down the road, as these are unenforceable if no agreement can be reached at that “down the road” time.

If flexibility is to be built into the tax structure, somebody – either the estate or the surviving shareholders – has to have the right to decide how to apply the flexibility. How flexibility is applied could mean advantages for some shareholders and disadvantages for others. This means that the shareholders have to make a fundamental decision when signing the shareholder agreement: will the estate or the surviving shareholders have the primary benefit of the flexibility?

In most cases, shareholders will choose to have the flexibility provisions primarily benefit the estate of the deceased shareholder. This might be due to a natural sympathy for the deceased, or it might be based on the conundrum of not knowing who will be the first to die. Whatever the reason, most shareholder agreements tend to give the estate the first shot at tax efficiency.

Surviving Spouse Issues

If there is a possibility of a surviving spouse, it will usually be desirable to have the shares of the deceased "vest indefeasibly" in the surviving spouse (or a spousal trust for the surviving spouse). This will allow the estate of the deceased to claim a full or partial rollover on the transfer of the shares to the spouse or spouse trust. The ability to claim rollover treatment might be useful if the capital gains exemption is not available or is insufficient to cover the entire capital gain. If the estate uses up the capital gains exemption of the deceased on the deemed disposition on death, it might be possible for the spouse or a spousal trust to use the spouse's capital gains exemption on the excess portion of the capital gain. As well, a spousal testamentary trust qualifies to pay income tax at graduated rates and might want to trigger the capital gain over several years so as to take advantage of graduated income tax rates on any capital gain that does not qualify for the exemption.

In order to put the estate in position to take advantage of the above strategies, the shares owned by the deceased must "vest indefeasibly" in the spouse or spousal trust no later than 36 months after death.[31] If the spouse or spouse trust is required to sell the shares to surviving shareholders pursuant to the terms of the shareholder agreement, the shares will never "vest indefeasibly" in the spouse or spouse trust and the potential rollover will not be available.[32] This is because the spouse or spouse trust takes the shares subject to the obligation to sell them to the shareholders and so never acquires an indefeasible right of title in the shares.

In order to ensure that the shares vest indefeasibly, the spouse or spouse trust must receive the shares free of any obligation to sell. This can be achieved by having the shareholder agreement acknowledge the right of the deceased to transfer shares to the spouse or spouse trust provided that the spouse or spouse trust becomes a party to the shareholder agreement. The shareholder agreement could then give the spouse or spouse trust a "put" right, being a right to require a purchase of the shares (either by the surviving shareholders, the corporation or a combination of the shareholders and the corporation in the proportions determined by the spouse or spouse trust). To the extent that the spouse or spouse trust fails to exercise the "put" right by a certain date after the

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[31] ITA section 70(6). The 36-month period can be extended in certain cases, provided that application for the extension is made before the end of the 36 months.

[32] See *Parkes Estate*, 86 DTC 1214 (TCC) and *Greenwood Estate*, 90 DTC 6690 (FCTD), affirmed 94 DTC 6190 (FCA). See also paragraph 8(d) of archived *Interpretation Bulletin* IT-449R.

death, the surviving shareholders would then have a "call" right, being an option to purchase (or to cause the corporation to purchase) the remaining shares held by the spouse or spouse trust. This way, the spouse or spouse trust acquires the shares before any mandatory sale obligation is triggered. Through its prior right to exercise the put option, the spouse or spouse trust has first choice on the way in which the purchase is effected (criss-cross purchase, corporate repurchase or a combination of the two). If the spouse or spouse trust does not exercise that first choice, the surviving shareholders get to choose.

Mandatory Sale and Election

If there is no likelihood of a surviving spouse or if there is no concern that the deceased might wish to use a rollover to a surviving spouse, it would be possible to provide for a mandatory sale by the estate.[33] To provide flexibility, the executors could be given a right to choose the extent to which the estate and the corporation would effect the purchase. Of course, the survivors could also be given this right to choose the identity of the purchaser. However, the usual preference is to allow the estate of the deceased to structure the purchase in the manner that is most advantageous to the estate.

Corporate-Owned Life Insurance

If life insurance will be used to fund the buy-out, the corporation often owns the life insurance policy. If the corporation pays the premiums, it is easier to ensure that the premiums are being paid on the lives of all shareholders. If the corporation pays tax at the small business rate, an income tax advantage arises because the premiums will be paid with the 82-cent after-tax dollars of the corporation rather than the 55-cent after-tax dollars of the individual shareholders.

If a corporation owns the life insurance policy, the beneficiary of the policy should not be an individual.[34]

Often, the owner of the policy will be a special-purpose corporation so as to protect the policy itself from creditors of the operating corporation.[35] In this case, the beneficiary will be the operating corporation so that the death benefit increases the capital dividend

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33 As discussed above, the shares of the deceased will not vest indefeasibly in a surviving spouse if the estate is required to sell the shares.

34 If an individual is a beneficiary of a corporate-owned life insurance policy, a taxable benefit is likely to arise under ITA section 15 (or some other applicable benefit provision).

35 Having a special-purpose corporation hold the policy also has an ancillary benefit. If a corporation is both the owner and beneficiary of the life insurance policy, the addition to the capital dividend account will be equal to the death benefit less the adjusted cost base of the policy. If a special purpose corporation owns the policy, the beneficiary corporation will have no adjusted cost base in the policy and the full death benefit will be added to the capital dividend account. However, the CRA has indicated that it might seek to apply the general anti-avoidance rule to reduce the capital dividend account if the only purpose of having the life insurance held by a special purpose corporation is to avoid the netting of the ACB against the death benefit.

account of the operating corporation given that the buy-out will usually occur at the operating corporation level. Of course, the operating corporation could both own the policy and be the beneficiary.

If the death benefit is paid to the operating corporation, the shareholder agreement will have to deal with who receives the benefit of the increase in the capital dividend account. If the buy-sell structure includes some of the above flexibility principles, the rules governing use of the capital dividend account can also be flexible.

The first instinct might be to stipulate that the capital dividend account is to be used for the benefit of the deceased. However, what if the deceased was able to shelter the entire capital gain through use of the capital gains exemption? In this case, it might be more beneficial to have the surviving shareholders get the benefit of the capital dividend account.

If the deceased was able to use the capital gains exemption to shelter only part of the capital gain and the life insurance death benefit covers only part of the value that is to be paid to the estate, will the capital dividend account be used for the benefit of the estate on a corporate re-purchase of the share value that is not covered by the capital gains exemption? Or will there be an attempt to split the capital dividend account between the deceased and the survivors (given that all shareholders covered the cost of the life insurance)?

To the extent that the corporation purchases the estate’s shares, the corporation will often be required to file a capital dividend election in respect of the deemed dividend that results on the corporate purchase. If the estate prefers to have the surviving shareholders purchase the estate’s shares, the common mechanism is to have the surviving shareholders issue a promissory note on the criss-cross purchase. The corporation would then usually pay a tax-free capital dividend to the surviving shareholders so as to provide the surviving shareholders with funds to pay the amount owing under the promissory note. If it is possible for the surviving shareholders to purchase the estate’s shares through holding corporations, however, it might be possible for the benefit of the capital dividend account to be retained by the surviving shareholders. In this case, the capital dividend would be paid to the holding corporations. While the holding corporations would use the dividend proceeds to pay the promissory note principal, the holding corporations will have increased their own capital dividend accounts through receipt of the capital dividend from the operating corporation. Payment of the promissory note principal would not decrease the capital dividend account of the holding corporation, which could pay future capital dividends funded by future taxable dividends received from the operating corporation.

If the plan is to use life insurance, of course, the life insurance must be purchased. It would also be useful to review the amount of life insurance annually in case additional insurance is required in light of the increased value of the shares. This assumes that it is possible to periodically increase the amount of the insurance.

A corporate-owned life insurance policy might affect the eligibility of shares for the capital gains exemption. The life insurance policy will likely be a non-active asset of the corporation, as the policy will have been acquired for the purpose of funding a buy-out and not for the purpose of carrying on the business activity.[36] Legislative relief is available in this regard, however.[37] These special valuation rules provide as follows.

1. At all times prior to the death of the deceased, the fair market value of the life insurance policy will be considered to equal its cash surrender value.

2. The value of the death benefit will be considered to not exceed the cash surrender value at the date of death provided that the death benefit is used within 24 months of death to acquire the shares owned by the insured. The acquisition can be direct or indirect.

While it is possible to apply for an extension of the 24-month time limit, any closing date provided for in the shareholder agreement should not be later than 24 months after the date of death.

The above rules are fairly broad and include policies that are owned by connected corporations. If a special-purpose insurance corporation owns the policy, it will be necessary to make sure that the above rules will apply to the chosen structure. The operating corporation will likely be the beneficiary of the policy in order to increase the capital dividend account of the operating corporation.[38]

Valuation of Shares

Corporate-owned life insurance will often be valued at its cash surrender value for purposes of the deemed disposition of the corporate shares on death.[39] However, this rule applies only in respect of life insurance on the life of the deceased or a person dealing with the deceased on a non-arm's-length basis. The cash surrender value rule would *not* apply in respect of life insurance owned by the corporation on the lives of arm's-length surviving shareholders. Given that the corporation will usually also hold life insurance on the lives of all shareholders, this may require that one look at factors other than cash surrender value when valuing the corporate shares. If the death resulted from an accident on a business trip and more than one shareholder was involved, the valuation of the corporate shares on the death of the deceased shareholder might have to take into account the possible imminent death of one of the surviving shareholders involved in the same

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[36] See CRA Technical Interpretation 9310129 (May 17, 1993).

[37] ITA section 110.6(15)(a).

[38] The special valuation rules will not apply to any excess buy-out insurance or to insurance acquired for purposes other than buy-out (such as insurance acquired to repay corporate debt). Conventional valuation principles will apply to the valuation of these other types of insurance, which could result in the value of the non-active assets disqualifying the corporate shares for the capital gains exemption.

[39] ITA section 70(5.3).

accident.[40] This could make the value of the insurance policy on that other life higher than cash surrender value (although having two key shareholders die might lower the value of the corporate shares and offset to some degree any increased valuation of the insurance on the critically-injured but still living shareholder). There might be some wisdom in having a policy that prohibits key shareholders from travelling together.[41]

The ITA rules governing the valuation of life insurance policies apply only for purposes of the ITA, of course. The shareholder agreement should contain its own rules for valuing corporate shares and should specifically deal with the valuation of life insurance policies held by the corporation.

If the shareholder agreement provides for a valuation formula, the value derived from the shareholder agreement might become determinative of the value of the shares. The CRA indicates that it will accept the value derived from the shareholder agreement if the following criteria are met.[42]

(a) The agreement must obligate the estate to sell the shares at death either under a mandatory sales and purchase agreement or at the option of a designated purchaser.

(b) The agreement must restrict the shareholder's right to dispose of his/her shares at any price during his/her lifetime.

(c) The agreement must fix a price for the shares or set out a method for determining the price on a current basis.

(d) The agreement must represent a *bona fide* business arrangement and not a device to pass the decedent's shares to his/her heirs for less than an adequate and full consideration.

Some additional considerations apply if the agreement is executed between non-arm’s-length parties.[43]

Even if the shareholder agreement value is not determinative of the share value, it will

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40 See paragraphs 40 and 41 of Information Circular 89-3, *Policy Statement on Business Equity Valuations* (August 25, 1989).

41 This policy could be in the shareholder agreement but could also be extended to include key non-shareholder personnel. However, such a policy is not without cost. Useful brainstorming sessions can sometimes occur during “down times” such as travel.

42 See paragraphs 17-31 of Information Circular 89-3, *Policy Statement on Business Equity Valuations* (August 25, 1989), especially paragraph 28.

43 See paragraph 29 of Information Circular 89-3, *Policy Statement on Business Equity Valuations* (August 25, 1989).

often be a significant factor in establishing share value.

Stop Loss Rules

Prior to 1995, it was possible to use life insurance to completely eliminate the capital gain on death (assuming that sufficient insurance was in place). This is no longer possible under rules introduced in 1995. However, the pre-1995 rules still apply to certain grandfathered arrangements. If dealing with shareholders who qualify for grandfathering treatment, it will be important to ensure that grandfathered status is not lost.

If a shareholder dies with shares that have an aggregate tax cost and paid-up capital of $1 and a fair market value of $100, the shareholder realizes a $99 capital gain (assuming no rollover to a surviving spouse). If the corporation purchases the shares from the estate for $100, the estate will have the following two tax consequences.

1. A deemed dividend of $99 (the $100 received from the corporation less the $1 paid-up capital of the shares).[44]

2. A capital loss of $99. The capital loss arises because the proceeds of disposition are reduced by the $99 deemed dividend.[45] As a result, the estate is deemed to have sold the share for $1 (the paid-up capital of the shares). The estate is deemed to have acquired the shares for $100 (the date-of-death fair market value).[46] Accordingly, a sale of the shares for deemed proceeds of $1 gives rise to a capital loss of $99. If the estate realizes the loss prior to the end of the initial taxation year of the estate, the estate can carry the $99 loss back and apply it against the capital gain realized in the date-of-death income tax return of the deceased.[47]

Under the pre-1995 rules, the capital loss resulted even if the entire deemed dividend was a tax-free capital dividend paid out of life insurance proceeds. If the capital dividend account generated by the life insurance death benefit was able to cover the entire amount of the deemed dividend, this resulted in the complete elimination of tax (the capital gain on death was nil and the deemed dividend was non-taxable). Under the new rules, the capital loss of the estate is reduced to the extent that the deemed dividend is a tax-free capital dividend.[48] To the extent that the capital loss of the estate is reduced, there is less capital loss to apply against the date-of-death capital gain. While the capital dividend is still tax-free, it is not possible to completely eliminate the capital gain that arose on the

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[44] ITA section 84(3).

[45] ITA section 54, paragraph (j) of the definition of "proceeds of disposition".

[46] ITA section 70(5)(b).

[47] ITA section 164(6).

[48] ITA section 112(3). The reduction is not a dollar-for-dollar reduction, however.

death of the deceased shareholder.[49]

If the stop loss rules apply and the paid-up capital of the share is equal to the tax cost of the deceased (i.e. the deceased acquired the shares from treasury), the capital dividend should generally not exceed 50% of the lesser of the estate's loss (otherwise determined) and the capital gain realized on the death of the deceased. If the capital dividend is larger than that 50% amount, there will usually be a reduction in the estate's capital loss carryback.

A difference in viewpoint might arise here between the surviving shareholders and the estate. If the capital dividend is larger than the above 50% threshold, the estate's loss carryback will likely be reduced. The surviving shareholders may consider that the capital dividend is wasted to the extent that it exceeds the 50% threshold and that it would be more tax efficient to save that excess capital dividend for use by the surviving shareholders at a later time. In order to save that excess capital dividend for the surviving shareholders, however, the estate might have to receive part of its buy-out amount as a taxable dividend. The top marginal rate on a taxable dividend is about 32% whereas the top marginal rate on a capital gain is about 22%. The estate might well prefer to receive its buy-out amount as a capital dividend because the estate then pays no tax on the dividend and pays only a 22% maximum rate of tax on the portion of the capital gain that cannot be eliminated due to the reduction in the loss carryback amount. The 22% capital gain tax might be less than the tax that the estate would have to pay on a taxable dividend that is received in order to avoid a reduction in the loss carryback amount. Of course, the amount of tax paid on any taxable dividend received by the estate will depend on numerous factors, including the tax rates of the estate beneficiaries and the number of those beneficiaries (to the extent that the dividend can be flowed through to beneficiaries). It might be prudent to address this possible conflict of viewpoints by having the shareholder agreement set out some principles to govern the use of the capital dividend account in this situation. Is the capital dividend account to be used for the benefit of the estate only to the extent that the receipt of a capital dividend by the estate does not reduce the estate's loss carryback amount? Or is the estate to be entitled to use the capital dividend account to the extent that the estate considers that the estate receives a benefit (even if the capital dividend might not be the most efficient use of the capital dividend account when viewed in the long run)?[50]

The stop-loss rules will be relevant only to the extent that the deceased has realized a capital gain on death. If the deceased avoided a capital gain by rolling the shares to a surviving spouse or a spouse trust, there will be no need for the estate to trigger a loss and carry that loss back to the terminal return.

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[49] For a more detailed discussion of the stop-loss rules, see an article by D. Keith Laushway, "Insurance Funded Shareholder Agreements and the Impact of the New Stop-Loss Rules", *1999 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1999), at pages 10:1-27.

[50] For further discussion of this issue, see an article by D. Kerry Hrabinsky, "Shareholder Buy-Sell Arrangements Under the New Stop-Loss Rules", *1998 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1998), at pages 4:1-42.

Pre-1995 Grandfathered Situations

Grandfathering provisions will allow the pre-1995 rules to apply the certain arrangements that were in place in 1995. If grandfathering is available, it will be important to retain grandfathered status. Two types of grandfathering rules remain relevant: the grandfathered agreement rule and the grandfathered policy rule.

Grandfathered Agreements

Grandfathering applies if the disposition occurs "pursuant to an agreement in writing that was made before April 27, 1995".[51]

While this appears to be quite generous at first blush, the CRA applies the rule very restrictively. The disposition must occur pursuant to buy-sell terms of the pre-existing agreement. Any change to the buy-sell terms of that pre-existing agreement could be fatal to grandfathered agreement status, as the buy-sell would now be effected under a (new) agreement that was made after the relevant date.

The CRA seems to take the position that grandfathered agreement status will be lost if any changes are made to a shareholder agreement (even changes that do not relate to the buy-sell arrangement). If non-buy-sell changes need to be made to a pre-existing shareholder agreement, the CRA will recognize grandfathered status if the parties conclude a separate agreement that leaves the existing agreement unchanged.[52] If the separate agreement cancels, nullifies or replaces the pre-existing agreement, however, grandfathered status will be lost. This presumably means that the separate agreement must deal only with matters that do not relate to the buy-sell arrangement in the pre-existing agreement.

The CRA takes the position that the mere addition of a new party (i.e. a new shareholder) or changes to price or payment terms will result in a loss of agreement grandfathered status.[53]

It could be argued that a pre-existing agreement continues in effect even if changes are made to the pre-existing agreement provided that the parties do not intend to effect a novation (a replacement of the original agreement by a new agreement). Given that this is not the CRA position, however, one must proceed very carefully when dealing with a

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[51] SC 1998, c. 19, s, 131(11)(a). This requires that the pre-existing agreement contain the buy-sell arrangement, of course. Merely having a shareholder agreement in place on April 27, 1995 will not be of assistance if the agreement contained no buy-sell provision, as the disposition would then not be pursuant to an agreement that was made before April 27, 1995.

[52] For a summary of the CRA position on the grandfathering rules, see *Income Tax Technical News 12* (February 11, 1998).

[53] See the response to questions posed during the Revenue Canada Round Table at the 1996 Ontario Tax Conference, reported in Volume 45, number 1 of the *Canadian Tax Journal*, pp. 206-21, at page 217.

pre-April 27, 1995 shareholder agreement. The safest approach would be to not change a pre-April 27, 1995 agreement at all. If changes need to be made in respect of matters that do not relate to the buy-sell arrangement, those changes should be placed in a separate agreement that specifically states that the separate agreement does not cancel, nullify or replace the original agreement.

Grandfathered Policies

Grandfathering also exists for insurance policies that were in place on April 27, 1995. If the shares in question are grandfathered under the grandfathered policy rule as well as the grandfathered agreement rule, it might be less crucial to keep the grandfathered agreement status (provided that grandfathered policy status can be maintained). It is sufficient if only one grandfathering rule applies.

Grandfathered status for pre-existing policies requires compliance with the following four criteria.[54]

1. The share must have been owned on April 26, 1995 by an individual (other than a trust) or by a particular trust under which an individual (other than a trust) was a beneficiary.

2. On April 26, 1995, a corporation (or a partnership of which a corporation was a member) must have been a beneficiary under a life insurance policy that insured the life of the individual or the individual's spouse.

3. It must have been reasonable to conclude on April 26, 1995 that a main purpose of the life insurance policy was to fund, directly or indirectly, in whole or in part, a redemption, acquisition or cancellation of the share by the corporation that issued the share.

4. The share must be disposed of to the corporation by one of the following categories of shareholders.

    (a) The individual or the individual's spouse or common-law partner.

    (b) The estate of the individual or of the individual's spouse or common-law partner, provided that the disposition is made within the estate's first taxation year.

    (c) The particular trust if it is a post-1971 spousal or common-law partner trust or a trust described in paragraph 104(4)(a.1) of the ITA, the individual's spouse or common-law partner (as the case may be) is the beneficiary referred to in item 1 and the disposition occurs before the end of the trust's third taxation year that begins after the death of the

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[54] SC 1998, c. 19, section 131(11)(b), as amended by SC 2001, c. 17. For CRA policy in respect of the grandfathered policy rule, see *Income Tax Technical News 12* (February 11, 1998).

individual's spouse or common-law partner, as the case may be.

(d) A trust described in section 73(1.01)(c) of the ITA created by the individual, or a trust described in section 70(6)(b) of the Act created by the individual's will in respect of the individual's spouse or common-law partner, provided that the disposition occurs before the end of the trust's third taxation year that begins after the death of the individual or the individual's spouse or common-law partner, as the case may be.

For the purpose of these rules, a share acquired in exchange for another share is considered to be the same share as the other share provided that one of sections 51, 85, 86 or 87 of the ITA applied to the exchange.[55]

Capital Gains Exemption

Shares do not qualify for the capital gains exemption if a significant portion of the capital gain has arisen due to the failure of the corporation to pay at least a minimal rate of annual dividends.[56] This restriction does not apply in the case of prescribed shares.[57] In general, common shares are prescribed for this purpose.

A share will not be a prescribed share if the shareholder has a right to cause the corporation to redeem, acquire or cancel the share.[58] While this could catch many shareholder buy-sell arrangements, there is an exception to the exception. a share can still qualify as a prescribed share if the redemption, acquisition or cancellation right arises under a written agreement made among shareholders of a private corporation provided that the shareholders who are party to the agreement own more than 50% of the voting shares. This will prevent most buy-sell arrangements from rendering common shares ineligible for the capital gains exemption. However, be careful of entering into a special buy-sell arrangement if the parties to the special agreement do not hold more than 50% of the voting shares of the corporation. An agreement among non-voting shareholders would not qualify.

If the shareholder agreement sets out dividend policies, ensure that the dividend policy does not cause a loss of prescribed share status.

Recharacterisation of Proceeds

The above discussion assumes that a corporate repurchase of shares will give rise to a deemed dividend and that a criss-cross purchase will give rise to a capital gain. While this is the normal rule, certain provisions in the ITA can transform a capital gain into a

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[55] SC 1998, C. 19, section 131(12).

[56] ITA section 110.6(8).

[57] ITA Regulation section 6205.

[58] ITA Regulation section 6205(1)(a)(i)(D).

dividend. The possible application of these provisions should be considered if the plan includes having intercorporate dividends or a purchase of shares by a corporate shareholder.

Section 84.1

Section 84.1 could apply on a criss-cross purchase if the purchaser is a corporate shareholder that is connected with the underlying corporation and the estate (vendor) does not deal at arm's-length with the corporate shareholder.[59] In this event, proceeds paid by the corporate shareholder might become a deemed dividend rather than a capital gain. As a simple example, assume that father and son are equal shareholders of Opco. Father agrees to sell his shares to the son. In order to pay for the shares with low-rate dollars, the son acquires the shares through a holding corporation (Sonco) so that the Sonco can pay for the shares by extracting tax-free dividends from Opco. Because father and son are related, the proceeds paid by Sonco to the father will be treated as a deemed dividend in the hands of the father. As a result, the father will not be able to claim the capital gains exemption on the sale of the shares.

It will be a question of fact whether a corporate shareholder deals on a non-arm's-length basis with the estate of a deceased shareholder. This would be the case if the principal of the corporate shareholder (the son in the above example) is executor of the estate or is related to the executor of the estate. As well, an extended meaning of non-arm's-length applies for purposes of section 84.1.[60] The extended definition would require that the estate or the estate executor have some interest in the purchasing corporate shareholder.

In general, section 84.1 will be a concern only if there is a mix of individual and corporate shareholders. It will not be a concern if all shareholders are individuals or if all shareholders are corporations.

Section 55

Section 55 could apply if the buy-out proposal involves the following.

1. The payment of an intercorporate taxable (in the sense of not a capital) actual or deemed dividend to a corporate shareholder, such that some portion of the dividend qualifies for deduction under section 112 and is not subject to Part IV tax (i.e. the recipient corporation is connected and the dividend does not trigger a refund of Part IV tax for the paying corporation).

2. A disposition of shares to a person who is not related to the corporation paying the dividend. In determining whether persons are related for the purpose of applying section 55, siblings are deemed to be unrelated to each other. As well, special rules apply to determine the related or unrelated status of a trust or estate.

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59 ITA section 212.1 should be considered if a non-resident shareholder is involved.

60 ITA section 84.1(2)(b) and 84.1(2.2).

3. The amount of the dividend exceeds the “safe income” that is allocable to the shares in respect of which the dividend is being paid. “Safe income” is essentially taxed retained earnings of the paying corporation and must be allocated to shares based on dividend entitlement concepts. In the case of a shareholder buy-out, however, at least part of the purchase proceeds will often relate to unrealized but accrued capital gains of the underlying corporation (unrealized increases in the value of corporate assets). Consequently, one can expect that at least part of the payout will exceed safe income levels.

Section 55 is an extremely complex provision that is subject to many exceptions and deeming rules. It is beyond the scope of this paper except to note that the provision should be considered whenever corporate shareholders are involved. The section need not be considered if all shareholders are individuals and there is no plan to involve corporate shareholders in the future.

Non-Resident Shareholder

Buy-out complications can arise if a shareholder is a non-resident.[61] While there is no need to obtain a section 116 certificate in respect of the deemed disposition on death, the normal clearance certificate rules will usually apply if the non-resident’s shares are disposed of pursuant to the shareholder agreement.[62] The clearance certificate procedure should be followed even if the capital gain arising on the disposition is exempt from Canadian tax under a tax treaty. While the purchaser has a statutory duty to withhold a portion of the purchase price if a clearance certificate is not obtained, the need for the certificate should be taken into account when setting the closing date for the purchase. Of course, a non-resident shareholder will have to take account of applicable tax treaty considerations as well as the rules of the home taxing jurisdiction when considering how to structure the buy-out. A capital gain might well be exempt from Canadian tax if the value of the corporation is not derived principally from Canadian real estate whereas Canadian withholding tax will likely apply in respect of any deemed dividend on a corporate repurchase of shares. However, the application or non-application of Canadian income tax might be irrelevant if the non-resident can claim a full foreign tax credit for the Canadian tax in the non-resident’s home jurisdiction.

Conclusion

This paper has attempted to show some of the ways in which shareholder agreement provisions can affect the current status of the corporation under the ITA, long before any buy-sell provisions kick in. In some cases, a need to avoid associated, related or affiliated corporation status will limit the available types of buy-sell provisions to rights of first refusal and shotgun clauses. Other types of buy-sell provisions might have

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[61] If a shareholder is a non-resident or controlled by a non-resident, of course, special attention must be paid to whether the shareholder agreement affects the status of the corporation as a Canadian-controlled private corporation. The rules relevant to this were discussed earlier in this paper.

[62] This assumes that the estate of the non-resident is also non-resident.

immediate adverse income tax consequences.