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BUY-SELL AGREEMENTS: FUNDING AND BASIC STRUCTURES

AN INTRODUCTION

A buy-sell agreement is key to any business plan with multiple business owners or interested successors. A well-crafted buy-sell agreement describes what happens to the shares of the business when a shareholder retires, becomes disabled or dies. It may also cover other events like disputes, bankruptcy or marital breakdown. A buy-sell agreement may be part of a more comprehensive shareholders' agreement. However, given the planning issues and level of detail in even a simple buy-sell agreement, it will likely be a separate document.

In private corporations, a properly funded buy-sell agreement gives the seller a market for their shares and the buyer a reliable source of funds to pay for those shares. In addition, a well thought-out and structured buy-sell agreement protects the interests of the business owner, their family, other shareholders, and the business. Identifying those interests and negotiating how the buy-sell agreement will allocate them provides value for the business and its principals.

This article is the first of three articles on buy-sell agreements. This article examines, at a high level, five of the most common funding options, emphasizing buy-sell agreements triggered by a shareholder's death. It also discusses buy-sell agreements with a surviving spouse, and the stop-loss rules.

Business owners can fund their buy-sell agreement in different ways – save the money, borrow it, or buy insurance. Each comes with its own advantages and disadvantages.

Business owners can also structure their buy-sell agreement in different ways. Different structures offer different opportunities for allocating tax, control of the business and financial compensation.

The second article in this series examines buy-sell agreements when the participants own their business through a corporation. The third article looks at buy-sell agreements when the participants own shares in their corporation through individually owned holding companies. Both articles describe how the business owners can use life insurance to implement their buy-sell agreement. In considering the different strategies, it can help to remember that there are only two basic methods for the remaining shareholders to buy out a departing shareholder's business interest:

1. The remaining shareholders buy the departing shareholder's shares.
2. The corporation buys back ("redeems") the departing shareholder's shares. With a redemption the remaining shareholders acquire the departing shareholder's economic interest in the business, proportionate to the shares they own, without directly buying that interest.

Each method produces different tax consequences. Sometimes business owners combine aspects of both methods in a "hybrid" buy-sell agreement to secure the advantages of one method without the drawbacks of the other.

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The application of the concepts presented in this paper may be explored in greater detail using software provided to your Sun Life wholesaler. A link to a sample client report prepared with this detailed and flexible tool appears on www.sunlife.ca/advisor, under Strategies & concepts — All sales concepts — Buy-Sell agreements. The page also contains links to a buy-sell check list and fact finder.

Once the parties to a buy-sell agreement have agreed on the agreement's structure and funding method, they can implement the agreement.

FUNDING A BUY-SELL

When a buy-out occurs because of a dispute or other non-health related issue, the buy-out occurs at an appraised fair market value (FMV), or at an amount calculated according to an agreed upon formula, or as the result of a "shotgun" price offering.[1] The buy-sell agreement should anticipate the type of buy-out, and how the parties will finance it. Often the seller will have to take back debt from the buyer in order to sell the business interest immediately – traditional lenders may be reluctant to extend credit to fund a buy-out that occurs unexpectedly.

On the other hand, the parties to a buy-sell agreement can often anticipate an owner's retirement. They can raise the cash to fund the buy-out by tapping their investments, or by accessing the cash values of life insurance policies they have purchased for key person protection or to fund the buy-out at death.

[1] A shotgun provision generally works like this. A and B own a business. A offers to buy B's interest in the business at a specific price. B must either accept A's offer, and sell their shares to A, or must make a counter-offer to buy A's shares at the same price. A shotgun clause will also provide a deadline by which B must decide. If B fails to decide by the deadline, B will have to sell their shares to A at A's initial offering price. A shotgun clause functions like a sudden and blunt divorce. If a business' owners can no longer agree, and the business is not functioning properly, it can be a fair way to end the relationship, provided both sides have roughly equal financial resources. Alternatively, the clause can be structured so that the triggering shareholder offers to sell their shares at a specific price per share, and the other shareholders can then accept the offer or sell their shares to the triggering shareholder at the same price. The timeline is generally very short, although there are no hard and fast rules. It would not be unusual to have 30 days to elect to sell or buy, and another 30 days to close. If the recipient of the offer does not respond in time, the offer is assumed to have been accepted.

Where funding for a buy-out is not in place when needed, the remaining owners, family members or employee purchasers may have trouble financing the departing owner's buy-out. The departing owner or surviving family members may have to take back debt for some or all of the sale proceeds, and may have to rely on the successors' ability and/or willingness to run the business well enough to pay off that debt. The successors may even find the debt burden too onerous to accept, and may refuse to carry out their obligations under the agreement.

A buy-out triggered by death or health problems can jeopardize the well-being of the business and the confidence of its suppliers, customers and financing institutions. That is the bad news. The good news is that most business owners have the means to purchase insurance that will provide the funds needed to buy out the deceased's or disabled owner's shares.

A properly funded buy-sell agreement protects all shareholders. It gives the outside purchaser or other shareholders the funds to buy out the departing shareholder. It gives the deceased shareholder's estate, or the disabled shareholder, a guaranteed market for their shares, and an immediate or assured payment of these proceeds.

This section examines several methods for funding a buy-sell agreement, each with its own cash flow and tax consequences. It will focus on the death of a shareholder, and will provide examples to illustrate different funding methods, using the same numerical fact pattern for each method, allowing for a comparison of their outcomes.

BUY-OUT AT DEATH

To compare the alternative funding mechanisms at death, we will assume two shareholders who each directly own 50% of the shares of a company with a total FMV of $2,000,000. The company was started from scratch with each shareholder having made nominal contributions to share capital.

Therefore, each shareholder has a nominal adjusted cost base (ACB) and paid-up capital (PUC) for tax purposes (we will assume nil in each case).[2]

Each shareholder needs $1,000,000 to buy out the other shareholder's business interest. Both shareholders receive employment compensation from the business and are in an assumed 50% marginal tax bracket. We will assume that their company pays tax at 15% on its small business income, and at 50% for its non-small business income (typically its investment income). Following are five financing options for the surviving shareholder to buy-out the deceased shareholder's interest in their business.

1. Remaining shareholder borrows (shareholders sell to each other)

The surviving shareholder personally borrows $1,000,000 to buy out the deceased shareholder's business interest. If we assume that the loan carries a 10-year term at 7% annual interest, the surviving shareholder will have to pay $1,423,775 over 10 years (or $142,378 per year) to repay the loan. We also assume that the surviving shareholder will deduct the interest portion – $42,378 per year – as interest on a loan incurred for the purpose of acquiring income-producing property, i.e. the shares, under paragraph 18(1)(a) of the Income Tax Act.[3] Although the surviving shareholder must maintain a cash flow of $142,378 per year to service the loan, they will save $21,189 per year in taxes from the interest deduction (assuming a 50% marginal tax rate).

Throughout these articles, we will assume that the tax benefits from interest deductibility accrue to the shareholder in the same year that they pay the interest, and therefore reduce their cash flow requirement. This could happen if the shareholder was paying tax by instalments and could

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[2] Adjusted cost base (ACB) is the cost for a property, like an interest in a business, plus the cost of acquiring it, like commissions and legal fees. Paid-up capital ("PUC") is the expression used by the Income Tax Act to refer to the shareholders' capital. In general, PUC may be returned to shareholders of a corporation, including non-resident shareholders, free of tax. All other corporate distributions are either dividends or taxable shareholder benefits. PUC is therefore relevant in determining the tax consequences of corporate reorganizations, distributions and dissolutions. Also, throughout this article we will be referring to "adjusted cost base" by the acronym, "ACB," but will be spelling out "adjusted cost basis" in full.

[3] The Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the Act. All legislative references in this article will be to the Act unless otherwise stated.

factor the tax deduction into the instalment payment. If not, the shareholder would need enough cash flow to pay the entire $142,378, and would only obtain a tax deduction after filing their tax return the following year.

Purchase price	$1,000,000
Cumulative interest over 10 years	423,775
Total paid over 10 years	$1,423,775
Annual payment	$142,378
Annual personal cash flow requirement if interest is deductible	$121,189
Additional annual compensation surviving shareholder needs to service the debt (if interest is deductible)	$242,378
Total additional compensation required over 10 years	$2,423,775

In summary, to provide the additional income that will allow the surviving shareholder to repay the $1,000,000 personal loan, the corporation will need to generate $2,423,775 in additional compensation for the surviving shareholder over the next 10 years.

Before committing to this type of agreement, the shareholders should think carefully about whether they could or should take on this kind of debt immediately after a shareholder has died. Debt financing may be difficult or expensive to secure, if it is available at all. To the extent that the purchaser may not be able to borrow enough money from a financial institution, the deceased shareholder's family may have to give back debt. This will expose them to the success or failure of the business in the following years and will force them to depend on the skill and care of its successor owners.

The parties should also consider that the deceased shareholder will have a deemed disposition of $1,000,000, and a taxable capital gain of $500,000, generating taxes due of $250,000. The

selling shareholder could reduce this tax burden by using the lifetime capital gains exemption (LCGE).[4]

2. Corporation borrows and redeems shares

The corporation borrows $1,000,000 at 7% over a 10-year repayment period. As above, the interest is assumed to be deductible.[5] We will assume that the corporation pays tax at an assumed 50% investment tax rate on the money the corporation needs to repay this debt, not the lower 15% small business tax rate:

Purchase price	$1,000,000
Cumulative interest over 10 years	423,775
Total paid over 10 years before tax reduction for interest	$1,423,775
Annual payment	$142,378
Annual corporate cash flow requirement if interest is deductible	$121,189
Annual additional profit required to cover the loan payments	$242,378
Total additional profit required to be generated over the 10 years	$2,423,775

[4] The LCGE on small business shares is $913,630 in 2022, indexed to inflation.

[5] The Canada Revenue Agency (CRA) has challenged the deductibility of interest on money borrowed by a corporation to redeem its shares. See Income Tax Folio S3-F6-C1, Interest Deductibility, paragraphs 1.45 – 1.52, and 1.65, for the CRA's current position on loan interest for a share redemption in light of court decisions that have allowed the deduction. The CRA's guidance contained in its interpretation bulletins, responses to taxpayer inquiries and advance tax rulings is the CRA's interpretation of the law on a given subject and can help taxpayers plan their affairs in order to comply with the law. However, the CRA is not bound by what it says in its interpretation bulletins or by its responses to taxpayer inquiries. The CRA is bound by the ITA and Regulations, and by judicial decisions, all of which have the force of law. It is also bound by the Advance Tax Rulings (ATR) it issues, but only to the individual taxpayer who requested the ruling, and only as long as the circumstances outlined in the request for the ATR remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.

In summary, the company must generate additional revenues of $2,423,775, or $242,378 per year for 10 years, to repay the loan, the same as the shareholder personally borrowing. Corporate borrowing to fund a buy-sell agreement may be preferred where the corporate tax rate is less than the personal rate. However, the corporation may have trouble borrowing the required funds following an owner's death for the same reasons that a surviving shareholder may have.

The deceased shareholder's family receives $1,000,000 as the proceeds of share redemption. The redemption proceeds in excess of the shares' PUC (here assumed to be nil) will be treated as a taxable dividend, generating an estimated tax liability of $450,000.[6] Provided the estate acts in the first year following death, it may be able to treat the redemption as a loss for tax purposes, and transfer that loss to the deceased's final tax return. Through this process, the deceased's taxable capital gain can be partly or fully eliminated, leaving only the dividend as the remaining tax liability. This strategy is discussed later in this article under the heading, "Loss carryback."

3. **Corporation redeems shares over time from corporate earnings**

Rather than borrow to redeem all the shares at once, the company redeems the shares over a specified period of time from after-tax earnings. The redemption proceeds greater than the shares' PUC (here assumed to be nil) will generally be treated as a taxable dividend to the estate of the deceased (selling) shareholder. The costs for the company are as follows:

[6] This estimate assumes that the dividend will not qualify as an "eligible dividend" that is taxable at the lower of two dividend tax rates under the Act. Generally, non-eligible dividends, taxed at the higher rate, will originate in corporate income taxed at the reduced rate for small business income. Here, we assume a 45% dividend tax rate.

Purchase price	$1,000,000
Annual payment (after tax paid at 15%)	$100,000
Annual additional pre-tax profit required to cover the redemption proceeds	$117,647
Total additional pre-tax profit required to be generated over the 10 years	$1,176,471

We calculate the additional pre-tax profit required in this example by dividing $100,000 by 1 – 15%. 15% of $117,647 is $17,647.

The seller's estate may want to freeze their interest in the business from common to preferred shares, since the value of the common shares could grow (or decline) over the 10-year redemption period. Preferred shares could also pay dividends that would provide an income to the surviving shareholder and compensate the shareholder for the delay in receiving full payment.

This scenario will work only if the selling shareholder's estate is willing to wait 10 years to receive full payment, and only if the surviving shareholder is willing and able to have the corporation redeem the shares over that same 10 year period. In addition, this funding option may leave the deceased shareholder's estate with insufficient cash to meet its tax liability when it falls due.[7]

[7] The deceased owner will owe tax on the shares, which are deemed to be disposed of immediately before death and acquired by the deceased's estate: subsection 70(5). While it is possible for the tax liability on the deemed disposition of the shares to be paid in instalments over as much as 10 years, this will require giving the CRA security for the outstanding balance (such as a lien on the shares) and payment of interest at a prescribed rate (5% for the first quarter in 2022): see subsections 159(5) and (7) and Form T2075 Election to Defer Payment of Income Tax, Under Subsection 159(5) of the Income Tax Act by a Deceased Taxpayer's Legal Representative or Trustee. The estate may carry back certain tax losses to offset the deceased's tax liability but only by electing to do so in the first year of the estate: subsection 164(6).

4. Liquidate personal or corporate assets

When the intended purchasers or the corporation have enough cash or near cash assets, they may be able to fund the buy-out using those assets. The cost of funding the redemption will be $1,000,000.

A problem with this strategy is that business owners rarely keep large amounts of cash on hand. Instead, they invest excess cash flow back into their businesses, where they can earn potentially higher returns.

However, consider a business that owns a capital asset it no longer needs, such as a building that has appreciated in value and has been partially depreciated for tax purposes. Assume the asset has an ACB of $1,000,000, FMV of $1,400,000 and capital cost allowance previously taken of $400,000.

Based on a tax rate of 50%, the sale of this asset generates the following net cash flow that the business can use to redeem the deceased shareholder's shares.

Proceeds of sale of property	$1,400,000
Less	
Recapture: $400,000 at 50% tax rate	(200,000)
Capital gains tax: 50% on 50% of $400,000	(100,000)
Selling costs: 5% of $1,400,000 sale price	(70,000)
Net after-tax cash received on disposal of the property	$1,030,000
Required for redemption	$1,000,000

The total cost to raise the $1,000,000 is close to $1,400,000 in this case.

5. Life insurance

Life insurance is usually the most cost-efficient, tax-efficient and risk-free method for funding a share purchase or redemption when a shareholder dies. Life insurance provides funds exactly when they are needed, and is available in a range of products and prices to suit many different needs.

A well-crafted buy-sell agreement will not only stipulate that insurance will fund the buy-out; it will also state the amount and type of coverage, and may list the policies in an appendix to the agreement.

Annual life insurance premiums[8] can range in cost from as little as 0.1% to 10% or more of the required coverage. The exact amount will depend on the type of policy purchased, the age and health of the life insured person, and the duration over which premiums are paid.

Many types of life insurance policies are available for funding a buy-sell agreement. For example, subject to underwriting requirements, a 40-year-old male non-smoker can obtain:

- Ten-year renewable term coverage of $1,000,000 with an annual premium of $595 (less than 0.1% per year of the death benefit). However, premiums will rise to $4,965 at renewal in ten years (still under 0.5% per year of the death benefit), to $12,045 at the next renewal 10 years after that, and so on every ten years until coverage expires.[9]
    - This solution may suit parties to a buy-sell agreement with limited funds or who expect to dispose of their interests in the business during the policy's term.

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[8] Some insurance policies, such as "universal" life insurance, a popular type, may direct payments in excess of the cost of the insurance component to a savings component.

[9] Based on a Sun Term 10-year term life insurance policy, issued on a 40-year old male non-smoker, risk class 3 (good health and lifestyle), as of January 12, 2022.

- Universal life coverage of $1,000,000 with a level face amount and level annual premiums for life of $11,135[10] (slightly more than 1% per year of the death benefit).
  - This solution provides permanent coverage with a level death benefit and level premiums. The policy builds very little cash value. It's therefore best to think of this solution as providing money to fund a buy-out at the life insured person's death instead of a source of cash during their lifetime.
  - A level death benefit may suit parties to a buy-sell agreement who have implemented an estate freeze, where share values will not increase.
- Universal life coverage of $1,000,000 plus fund value with an annual premium payable for 10 years of $41,655. Unlike the previous two examples, this example contemplates paying higher premiums than needed to keep the policy in force (subject to the limits for a tax-exempt life insurance policy) for a limited time only. Cash values accumulate in the policy, and grow tax-deferred. At death, the amount paid as a death benefit equals the initial face amount - $1,000,000 – plus an amount equal to the policy's cash value at the date of death. Further, after ten years premiums stop, with the policy remaining in force using its accumulated cash values. However, there is no guarantee that the policy will remain in force for the life insured person's life without ever having to pay premiums. Depending on the size of the policy's cash value account at the end of ten years, and on future (non-guaranteed) returns in that account, the policy owner may or may not have to pay additional premiums in the future.

[10] This example and the next use a SunUniversalLife Pro policy illustrated at 2% interest, using the same life insured as the term life insurance example. See the complete policy illustration for the projected performance of the policy with alternative rates.

During the life insured person's lifetime, the policy owner can access the policy's accumulated cash values at any time through a policy loan or withdrawal, or by pledging the policy as security for a loan from a financial institution. If the life insured person retires or leaves the business (for example, after a dispute or disability), the loan or withdraw may serve to fully or partially redeem the departing owner's interest in the business. However, some or all of the funds accessed through policy loans or withdrawals may be subject to tax.[11] A policy owner can also access a policy's cash value by pledging the policy as collateral for a loan from a third-party lender. Proceeds from a third party loan generally are not taxable, but in some circumstances there may be other tax consequences associated with the loan, such as the need to pay a guarantee fee, or the requirement to pay out the borrowed amounts as a taxable dividend.[12] Further, if the policy owner accesses policy cash values those values may not be available to sustain the policy without having to pay premiums.

- The increasing death benefit may be more consistent with a buy-sell agreement for a growing business. To maximize the benefit of tax-deferred growth in exempt life insurance contracts (for example, to make it available for a living buy-out), this strategy should be implemented a minimum of 10 to 15 years before the anticipated buy-out date.

[11] Subsection 148(1) and paragraph 56(1)(j) set out the rules that require part or all of a policy loan or withdrawal to be included in computing the policy owner's income as the disposition of an interest in a life insurance policy.

[12] Where the loan is from a qualifying lender, there is a business or investment purpose for the loan, and the lender requires the policy as collateral, the company may be able to deduct a portion of the premium or annual net cost of pure insurance, whichever is less, as an expense: paragraph 20(1)(e.2).

Other contingencies: Disability and critical illness

Business owners often use insurance to fund buy-sell agreements where contingencies other than death (like disability and/or critical illness) can cause an owner to leave the business.

Disability insurance

Disability insurance is generally harder to obtain and more costly than life insurance because the risk of a long-term disability before retirement is greater than the risk of dying. Disability insurance policies are available to fund lump sum or staged buy-outs. The cost for disability insurance varies by age and degree of insurability.

Critical illness insurance

Critical illness insurance pays a lump sum benefit following the diagnosis of one of a list of covered life threatening illnesses, such as cancer or stroke; serious medical conditions, such as loss of limbs or severe bums; and major medical procedures, such as coronary artery bypass surgery or heart valve replacement. The benefit is payable when the event occurs. There is no need to verify any inability to work in an occupation, or to claim reimbursement for specific expenditures. The cost for critical illness insurance varies by age, insurability and policy features selected.

STRUCTURING THE FUNDED BUY-SELL

There are many ways to structure a buy-sell agreement. All are variations on two basic transactions:

1. New or existing shareholders may purchase the shares from the selling shareholder, or
2. The corporation can buy back, or redeem, its shares.

The tax consequences vary for each scenario. They may be combined in a hybrid arrangement to produce a tax outcome that will reflect the circumstances and bargaining positions of the parties to the agreement.

This section assumes that the parties to the buy-sell agreement have chosen life insurance to fund their agreement, and presents an analysis of alternative strategies based on a common fact scenario.

PARTIES TO THE BUY-SELL AGREEMENT

The examples in the balance of this article, and in the second and third articles, introduce the following parties to a buy-sell agreement: an incorporated operating business (Opco) and two shareholders, A and B. In the second article, A and B own Opco directly. In the third article, A and B own Opco indirectly through their respective holding companies, Holdco A and Holdco B.

In addition to Opco's owners, Opco itself will be a party to the agreement where Opco has to do something to implement the agreement, such as buying life insurance, redeeming its shares or making an election authorized under the Act. In those cases, as a practical matter A and B will direct the required corporate actions and will undertake in the agreement to cause Opco to carry them out. However, where Opco is a participant in the buy-sell arrangement, it is customary to include Opco as a party to clarify its role, and the examples in this paper do so as well.

OWNERSHIP OF THE INSURANCE POLICIES: CORPORATION OR SHAREHOLDERS?

The business owners will have to decide who owns the insurance. There are two basic choices:

1. The owners of the business will own insurance on each other, or
2. The company will own insurance on the owners.

Some of the common funding strategies discussed in this paper require the shareholders to own the life insurance policies; others require corporate ownership.[13] The following factors may also influence the decision.

[13] For more details see our guide, "Corporate ownership of a life insurance policy," available at https://www.sunlife.ca/slfas/en/strategies-and-concepts/financial-advisor-bulletins/corporate-ownership-of-a-life-insurance-policy/.

Cost: Insurance premiums are generally not tax-deductible; they are paid from after-tax income. The premiums will therefore be less expensive after-tax for a corporation if the corporation's tax rate is lower than the tax rates of its owners.

Administrative efficiency: If there are more than two shareholders, it will be more efficient and less expensive for the corporation to own policies on each of its shareholders than for each shareholder to own policies on all the others. A shareholder will also have access to corporate information, and will be able to ensure that the corporation has purchased and is paying for the intended policies. Note, however, that if the shareholders do not want their corporation to own the policies, they may achieve similar results by having a trustee own and pay for the policies on their behalf.[14]

Unequal premiums: The cost of insuring individual shareholders may vary greatly depending on their differing ages or health. If the shareholders individually own policies on their co-owners' lives, the younger, healthier shareholders will pay higher premiums to insure the lives of the older, less healthy shareholders. The older shareholders will pay lower premiums to insure the lives of the younger shareholders, even though the older shareholders may have the higher incomes. If the corporation owns all the policies, however, the total premium cost will be borne by all shareholders in proportion to their ownership interests. The shareholders can view the premium expense less as an individual burden and more as a collective (and proportionate) expense they all bear to preserve their business' continuity.

[14] In Quebec, the framework for trusts created by the Civil Code of Québec, CQLR c CCQ-1991 (referred to herein as the Civil Code), does not permit a "bare trust" such as the arrangement described here, where a trustee holds and administers insurance policies as an agent for the parties to a buy-sell agreement. Throughout Canada, careful planning is needed for a trust to avoid unintended tax costs to the trust or, by attribution, to its settlors. For example, if the trust is created to pay the insurance premiums from trust income, possibly from dividend-paying shares transferred to the trust, the income will be taxed at the highest personal rate: subsection 122(1). Also, if the trust is the beneficiary of the life insurance policy instead of the corporation, the proceeds on death will not qualify for a credit to the corporation's capital dividend account.

Creditor protection: Under the Quebec Civil Code, insurance contracts are protected from creditors' claims where the beneficiary is a qualifying family member (spouse, "descendant or ascendant") in relation to the policy owner.[15] To achieve creditor protection, the policy owner must therefore be an individual and not a corporation. Outside Quebec, however, provincial insurance acts protect insurance contracts from seizure by creditors where the beneficiary is irrevocable or a qualifying family member in relation to the life insured,[16] no matter who owns the policy. A corporation cannot name itself as an irrevocable beneficiary, and it cannot name a family member of the life insured without the Act treating the premiums it pays as a taxable shareholder benefit for the life insured. Therefore, it is not possible for a corporation owning a life insurance policy to obtain creditor protection by naming an appropriate beneficiary under a provincial insurance act. There may be a concern that, if the Opco or individual shareholders are policy beneficiaries, their creditors may seize the policy proceeds and thereby defeat the buy-sell agreement. One option is for the shareholders to use holding companies to own the life insurance policies, and for those holding companies to be named as beneficiaries, since a holding company is less likely to have creditors than an operating company or shareholder.

When a corporation owns the policies, and there are only two shareholders, the corporation may consider purchasing a joint first-to-die policy rather than separate policies on each shareholder. In most cases, however, separate policies will be preferable if there is a corporate purpose for life insurance apart from funding a buy-sell agreement. A separate policy on the life of the surviving shareholder that is underwritten after the first death will be issued at the rate for the survivor's attained age and will therefore be more expensive.[17]

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[15] Civil Code, Article 2457. References in this article to the Civil Code will be by article number. Note, however, that an irrevocable beneficiary designation will also confer creditor protection without limiting the nature of the beneficiary: Article 2458.

[16] For example, the Insurance Act (Ontario), R.S.O. 1990, C. I.8., s. 196(2). S. 191(1) provides for creditor protection by means of an irrevocable beneficiary designation, regardless of ownership of the policy or the nature of the beneficiary.

[17] Sun Life Financial joint first-to-die policies provide that, within 31 days of the death of the first insured person, the surviving insured person may buy life insurance to replace the joint coverage without providing evidence of insurability but at the rate for the survivor's attained age. The base coverage amount is paid out twice if both insured persons die together or within 31 days of each other.

REVIEW OF BASIC PLANNING CONCEPTS

This part of the article summarizes basic planning concepts that underlie strategies for funding buy-sell agreements.

1. Loss carryback

This technique may reduce or eliminate the capital gains tax payable on the shares of a deceased shareholder in a private corporation. The deceased is deemed to have disposed of the shares in their company immediately before death for proceeds equal to the shares' FMV. The shares go automatically to the deceased's estate. The executor sets the estate's adjusted cost base (ACB) in the shares equal to the shares' FMV immediately before death ($1,000,000 in this case).

The executor then has the corporation redeem the estate's shares for proceeds equal to FMV. The Act deems those proceeds to be paid to the estate as a dividend. To the extent the redemption proceeds are treated as a dividend they reduce the proceeds of disposition for the estate for capital gains tax purposes. As a result, for dividend tax purposes, the estate receives and pays tax on a $1,000,000 dividend. But for capital gains tax purposes, it is deemed to receive far less (nil in our example). Indeed, with an ACB equal to $1,000,000, but deemed proceeds of disposition equal to nil, the estate sustains a $1,000,000 capital loss. If the executor acts within the first year after death the estate can transfer that loss to the deceased's final tax return to full or partly offset the deceased's capital gain.

The following describes the steps necessary to accomplish the "loss carry-back" in more detail. Some steps occur automatically under the tax rules. Others require the corporation or executor to "elect" or choose to take it. The steps are, highly simplified:

- According to the Act, the shareholder is deemed to dispose of their shares immediately before death to the shareholder's estate at their FMV (e.g. $1,000,000).[18]
- The shareholder realizes a capital gain equal to the proceeds of disposition ($1,000,000) less their cost, adjusted for tax purposes ("adjusted cost base" or ACB, nil in our case). The capital

[18] Paragraph 70(5)(a).

gain is $1,000,000, half of which ($500,000) is reported on the taxpayer's final return as taxable income.

- The shareholder's estate acquires the shares at their FMV, $1,000,000, which becomes the ACB of the shares to the estate.[19]
- The corporation redeems the shares (or buys them back) from the shareholder's estate for $1,000,000.
- According to the Act, the shareholder's estate is deemed to receive the redemption amount, $1,000,000 (less any paid-up capital, here assumed to be nil), as a dividend.[20]
- To avoid exposing the estate to tax twice on the $1,000,000, once as a dividend and a second time as potentially taxable proceeds of the disposition of those shares, the proceeds of disposition ($1,000,000) are reduced by the amount of the dividend (also $1,000,000). This results automatically from paragraph (j) of the definition of "proceeds of disposition" in section 54 of the Act. The proceeds of disposition of the shares by the estate therefore become nil.
- The estate realizes a capital loss on the disposition of the shares: its adjusted proceeds of disposition (nil) minus the ACB of the shares to the estate ($1,000,000). The capital loss of the estate in this example is therefore $1,000,000.
- The Act permits the estate to carry back the capital loss of $1,000,000 to the deceased shareholder's tax return, provided it does so in the estate's first taxation year. When the estate does so, the estate's $1,000,000 capital loss cancels the shareholder's $1,000,000 capital gain, resulting in a taxable capital gain of nil and no tax for the deceased shareholder.
- Result:
  - The deceased shareholder pays no tax on the deemed disposition of the shares.
  - The remaining shareholders acquire a proportional value of the deceased shareholder's interest in the company at no cost. When the shareholders dispose of their shares, the acquired value will be exposed to taxation as a capital gain (provided, of course, that subsequent business losses do not erode the gain so acquired).
  - The estate receives a $1,000,000 dividend, which may or may not be taxable (see the sections below on the capital dividend account and stop-loss rules).

[19] Subsection 164(6).
[20] Subsection 84(3).

2. Capital dividend account

A private corporation can use the capital dividend account (CDA) to record various amounts that it receives tax-free so that it can pass them on to its shareholders tax-free.[21] Examples include the tax-free 50% of a capital gain and the death benefit paid under a life insurance policy (minus the policy's adjusted cost basis immediately before death).

The CDA is calculated for tax purposes only. It is a running balance of the amounts that a private corporation can pay to its shareholders tax-free. It does so by electing to pay a capital dividend following a required procedure.[22] Therefore, a third example of a tax-free receipt that may be credited to a private corporation's CDA is a capital dividend received from another private corporation.

The CDA is only a bookkeeping record, not a separate corporate asset. Provided there is a sufficient balance in its CDA, a private corporation can elect to designate a payment to its shareholders as a tax-free capital dividend when it has the cash from any source. When it makes the payment, its CDA is reduced by a corresponding amount.[23]

3. Stop-loss rules (1995)

Before the introduction of the stop-loss rules on April 26, 1995, it was possible to eliminate tax on the deemed disposition of shares by the deceased shareholder. This was accomplished through a share redemption buy-sell funded by life insurance, as follows:

- The payment to the shareholder's estate for the redemption of the shareholder's shares was deemed to be a dividend equal to the difference between the redemption proceeds and the paid-up capital (PUC) of the shares. Where insurance to fund the buy-sell was paid to the corporation following the death of a shareholder, the insurance amount was credited to the

[21] "Capital dividend account" is defined in subsection 89(1).

[22] Subsection 83(2), Income Tax Reg. 2101 and Form T2054: Election for a Capital Dividend Under Subsection 83(2).

[23] For more details see our guide, "The Capital Dividend Account," available at https://www.sunlife.ca/files/advisorabc/english/pdf/The_Capital_Dividend_Account_E.pdf.

corporation's CDA to the extent the insurance amount exceeded the policy's adjusted cost basis immediately before death. It was possible to elect that the deemed dividend paid on the redemption was a tax-free capital dividend. Therefore, the estate could pay little to no tax on the redemption.

- The shareholder's estate was deemed to receive the shares at FMV. For purposes of determining the capital gain to the estate on the disposition of the shares, and to avoid taxing the same amount as both a capital gain and a dividend, the amount that the shareholder's estate received for the shares was reduced to nil by the amount that it received as a deemed dividend. The redemption therefore also created a loss in the estate that could be carried back to offset the gain on the deceased shareholder's final tax return.[24]

In the end, neither the deceased shareholder nor their estate paid any tax (or very little, depending on how much of the insurance proceeds could be posted to the corporation's CDA). Tax on the deceased shareholder's latent capital gain would be paid only when a subsequent shareholder disposed of their shares, provided the shares retained their value until the subsequent shareholder's death.

The Department of Finance determined that this was an unwarranted deferral of capital gains tax. The government introduced legislation, applicable to transactions after April 26, 1995, to reduce the tax loss that could be transferred to the deceased's final tax return through use of the share redemption buy-sell method on the death of a shareholder.

These rules became known as the "stop-loss" rules. They have greatly reduced the redemption method's tax efficiency when life insurance proceeds fund a share redemption after the death of a shareholder, and provide a largely or fully tax-free payment to the estate of the deceased shareholder. The stop-loss rules restrict the loss amount that can be carried back to reduce or eliminate the gain of the deceased shareholder on the deemed disposition of their shares at death.[25]

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[24] For details, see "Loss carryback" earlier in this paper in "Section II – Structuring the funded buy-sell" under "Introduction—Review of basic planning concepts".

[25] Subsection 112(3) (loss on share) and subsection 112(3.2) (loss on share held by a trust).

The stop-loss rules grind down or "stop" the loss created when the estate redeems its shares. They don't affect how much of the dividend the corporation can elect as a capital dividend. The amount of the loss "stopped" is calculated as:

The lesser of

1. The capital dividend received by the estate, and
2. The capital loss minus any taxable dividends received by the estate.

Minus 50% of the lesser of

1. The estate's capital loss, and
2. The deceased's capital gain from the deemed disposition on death.[26]

The stop-loss rules let the estate carry back losses created by the redemption only to the extent of the non-taxable portion of the capital gain on the disposition of the shares. The stop-loss rules effectively increase the tax on redemption from nil to roughly half or more of what the tax would be without the stop-loss rules.

Although the rules do not restrict a corporation from declaring any size of capital dividend the Act otherwise allows, electing a capital dividend greater than the non-taxable portion of the deceased's capital gain could be seen as "wasting" the capital dividend to the extent of the excess.

Consider the result when the estate elects to have the corporation pay all the share redemption proceeds to it as a capital dividend. The estate receives its dividend entirely tax-free (assuming ACB and PUC are nil). However, the estate can transfer only half its capital loss to the deceased shareholder. This is the same result for the deceased shareholder as arises from using the "50% solution" discussed in the second article in this series. However, under the 50% solution only half of

[26] Subsection 112(3.2) for loss on a share held by a trust, including a testamentary trust that administers the estate of a deceased shareholder.

the redemption proceeds are paid to the estate as a capital dividend; the rest are paid as a taxable dividend. The rest of the CDA is preserved for the surviving shareholder's later use.

How the redemption proceeds are distributed, using the 50% solution or not, depends on different factors, among them the deceased shareholder's and the estate's tax positions. The deceased may have access to the LCGE, and the corporation may be able to use refundable dividend tax on hand (RDTOH) credits to reduce tax on a taxable dividend. After those considerations are dealt with, it becomes a matter of negotiation for the parties as to how they will structure their agreement

4. Stop-loss "grandfathering" rules

Soon after the stop-loss rules became law, the insurance industry and other interested parties began to negotiate with the Department of Finance to correct some of the rules' unintended results, and to make the grandfathering rules relating to insurance or buy-sell agreements in place as of April 26, 1995 more fair. These grandfathering rules apply to shares that were owned on April 26, 1995 (or to shares received for those shares in certain corporate reorganizations).[27] Following is a high-level overview of the grandfathering rules.

Grandfathered life insurance policies

If life insurance was in place on April 26, 1995, and if the taxpayer can demonstrate that one of the main purposes of the insurance at that date was to provide the funds needed to redeem shares, then a subsequent share redemption at death will be grandfathered under the old rules. In addition, additional insurance purchased by the corporation after April 26, 1995 for this purpose will also qualify for grandfathering. The original policy may be replaced or converted, and coverage may be increased.[28]

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[27] The grandfathering rules appear in the coming-into-force provisions for amendments to subsections 112(3) and s. 112(3.2) (the stop-loss rules) in the Income Tax Amendments Act, 1997 (Bill C-28), enacted as S.C. 1998, c. 19, subsections. 131(11) and (12). The CRA published its interpretation of the rules in "Stop-Loss Provisions—Grandfathering," CRA Technical News No.12, February 11, 1998.

[28] CRA document 2005-0124311E5, June 28, 2005.

Grandfathered buy-sell agreement

Grandfathering will also be available when shares are redeemed pursuant to an agreement that was in place on April 26, 1995. This test is far more restrictive than the insurance test. One of the biggest concerns is the CRA's position that any amendment to the agreement after April 25, 1995 will cause the agreement to lose its grandfathered status.

The business can address this concern by drafting a new and separate agreement to make any necessary changes to the shareholder's agreement. However, while this new agreement might add new provisions, it must not in any way "cancel, modify or replace" the provisions of the original agreement.

Making necessary changes to an agreement (like adding or replacing shareholders) may force the business to sacrifice grandfathering protection. The loss of grandfathered status is irrevocable, though, and should never be allowed to occur inadvertently. The changes should always be undertaken carefully after first ascertaining that the agreement is grandfathered and, if so, after weighing the benefits of the changes against the value of a future grandfathered share redemption.

BUY-SELL PLANNING WITH A SURVIVING SPOUSE—PUT-CALL AND THE LCGE

A deceased shareholder's surviving spouse may be able to shelter the proceeds from a buy-sell from tax by using their LCGE and any LCGE the deceased shareholder may have claimed.

To accomplish this, the shares of the deceased shareholder must "vest indefeasibly" in the spouse within 36 months of transfer.[29] That is, the spouse must legitimately become the owner of the shares without any pre-determined obligation to sell the shares to the surviving shareholders.

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[29] Subsection 70(6). Note that in 2003 the CRA withdrew without explanation its 1987 Interpretation Bulletin, IT-449R "Meaning of "vest indefeasibly," but relocated it in a group of archived bulletins, with a warning to use "with great caution." Other interpretation bulletins continue to refer to IT-449R. When it was current, the bulletin stated:

> "A property vests indefeasibly in a spouse or child when such a person obtains a right to absolute ownership of that property in such a manner that such right cannot be defeated by any future event, even though that person may

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One way to satisfy the "vest indefeasibly" requirement, yet still transfer the shares to the surviving shareholders and allow the surviving spouse to use their LCGE, is through a "put-call" option. The shareholder agrees to leave their shares to their spouse so that when the shareholder dies the shares will vest indefeasibly with the spouse. The spouse also enters into a put-call agreement with the other shareholders. After the spouse acquires the shares they will have no obligation to sell those shares to anyone else under the buy-sell agreement. But if they want to sell them they can sell (or put) their shares to the surviving shareholders, who will have an obligation to buy them under the put-call agreement. Conversely, the surviving shareholders will likewise have no obligation to buy the shares under the buy-sell agreement. But if they want to buy them they may buy (or call) the shares from the surviving spouse, who will have an obligation to sell them.

Until one side exercises their option, no one has any obligation to buy or sell the surviving spouse's shares. Therefore, no one can say that the surviving spouse's shares haven't vested indefeasibly with that person. But if one side exercises their option, the transaction must take place. The essential condition is that none of the deceased shareholder, the shareholder's estate, or the spouse are under any obligation to sell or buy the shares before those shares vest indefeasibly with the spouse.[30]

not be entitled to the immediate enjoyment of all the benefits arising from that right" (para.1) "Where the terms of the buy-sell agreement provide that it is compulsory for the executor of the taxpayer's estate to sell and the other party to buy the shares, the shares will not be considered to vest indefeasibly in the beneficiary. Where, however, the terms of the buy-sell agreement merely give the other party an option to acquire the taxpayer's shares which may or may not be exercised and the taxpayer's executors transfer the shares to the beneficiary before the option is exercised, the shares will be considered to vest indefeasibly in the beneficiary at the time of the transfer" (para. 8(d)).

[30] See Parkes Estate, 86 DTC 1214 (T.C.C.), in which the shares did not vest indefeasibly in the spouse when the shareholder had entered into an agreement that required a share transfer to surviving shareholders, and Estate of Philip Van Son v. The Queen, 90 DTC 6183 (F.C.T.D.), in which the buy-sell agreement created an obligation on the survivor shareholders to purchase but did not create an obligation on the decedent or the estate to sell. In that case, the shares did vest indefeasibly.

This approach does, however, require the spouse to carry out the arrangements under the buy-sell if that agreement is to achieve its intended results. The put-call option also necessarily creates some uncertainty because both sides have to do something to move the shares to the surviving shareholders. In this sense, the put-call arrangement differs from most buy-sell agreements, which are triggered by a shareholder's death, not by a decision to put or call the shares.

When the spouse puts the shares, or the surviving shareholders call them, the spouse may have an opportunity to shelter their capital gains on the transfer of the shares with any existing LCGE that is available.

Assume, as in the earlier examples, that the deceased shareholder's shares have a FMV of $1,000,000 and an ACB and PUC of nil. Each of the deceased shareholder and the spouse has at least $500,000 remaining in their LCGE.

The shareholder leaves the shares to their spouse. Half are rolled over at the shareholder's adjusted cost base of nil under the spousal rollover provision of the Act.[31] The proceeds of disposition to the estate of the shareholder are nil, which becomes the adjusted cost base of the shares to the spouse. The spouse subsequently sells those shares to the surviving shareholders for $500,000, realizes a capital gain in that amount and claims the LCGE.

The deceased shareholder's legal representative elects to transfer the other half of the shares to the spouse at their FMV of $500,000, opting out of the spousal rollover that would otherwise apply automatically.[32] The deceased shareholder is deemed to have disposed of those shares immediately before death at their FMV of $500,000, crystallizing a capital gain of $500,000 and a claim against the deceased shareholder's LCGE.

[31] Subsection 70(6).

[32] The election to transfer a part of the property at FMV is permitted under subsection 70(6.2).

	No put-call	With a put-call		
	A (deceased) $1,000,000 deemed disposed at FMV	**A** (deceased) $500,000 deemed disposed at FMV	**Spouse** $500,000 sold to survivor at FMV	**Total** $1,000,000
Proceeds of disposition	1,000,000	500,000	500,000	1,000,000
ACB	0	0	0	0
Capital gain	1,000,000	500,000	500,000	1,000,000
Taxable capital gain (50%)	500,000	250,000	250,000	500,000
Capital gains deduction[33]	(250,000)	(250,000)	(250,000)	(500,000)
Capital gain subject to tax	250,000	0	0	0
Taxes payable (50% rate)	125,000	0	0	0

The put-call arrangement eliminates the $125,000 of tax that would otherwise have been payable

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[33] Because taxable capital gains and allowable capital losses are calculated at 50% of the underlying reported capital gains and losses, the LCGE is given effect by allowing a shareholder to claim a capital gains deduction from taxable income. Subsection 110.6(2.1) provides the capital gains deduction for "qualified small business corporation shares" by cross-referencing the calculation of the deduction for "qualified farm property" in subsection 110.6(2).

This paper is intended to provide general information about buy-sell agreements. It does not necessarily reflect the views of Sun Life Assurance Company of Canada or any related company, their sales representatives, their employees, their officers or their directors. Every reasonable effort has been made to ensure the accuracy and currency of the information provided as of the date indicated above, but all information and any examples are presented for the purposes of general explanation only and may be subject to subsequent changes in the law or its application by federal, provincial and territorial taxation agencies. No one should act upon the information or examples without a thorough examination of their particular legal and tax position with their professional advisors, after full consideration of the specific facts of their circumstances