

COMMENT

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THE NEED TO REVISIT SHAREHOLDERS' AGREEMENTS

The changes to the dividend taxation rules announced by Ralph Goodale (then finance minister for the Canadian government) on November 23, 2005, have a direct impact on how buy-sell arrangements could be structured as part of a shareholders' agreement.

Having an obligatory buy-sell arrangement with corresponding life insurance in place ensures the succession of the business in a smooth and seamless manner and makes certain that proper funding is in place to complete the arrangement when the contemplated circumstances arise. Just as important is the need to regularly review the agreement from an income tax perspective in terms of the deceased shareholder's after-tax position and the ongoing shareholder's go-forward position. The shareholders' agreement should address all of these issues.

The new dividend rules create a lower rate of tax for individuals on dividends received on corporate income that was previously subject to a high rate of corporate tax. This includes the after-tax corporate income above the small business deduction limit earned by a Canadian-controlled private corporation (CCPC).

On October 30, 2007, Jim Flaherty, current federal finance minister, announced a schedule of decreasing

corporate tax rates over the next five years. Similarly, many recent provincial government budgets have announced lower corporate tax rates. With decreasing corporate income tax on the horizon, CCPCs that traditionally opted to bonus down to the small business deduction limit will likely revise their strategy and pay tax on the corporate income above the small business deduction limit at rates much lower than in the past. Over time, a larger portion of a CCPC's retained earnings will be comprised of income that was taxed at top corporate rates. This changing trend means that it will become more important to have the shareholders' agreement address how this pool, referred to as "GRIP,"¹ should be distributed among the shareholders because of the tax preference it carries.

The table on the next page highlights the relationship between the effective rates of tax on a capital gain versus the effective rates of tax on eligible dividends as of 2010.²

In a buy-sell arrangement for a CCPC, the proceeds of the arrangement can be structured as a dividend or as a capital gain. Dividends would be preferable if there is a credit in the corporation's capital dividend account (CDA). Alternatively, capital gains would be preferable

¹GRIP is the General Rate Income Pool. In simple terms, this is the corporate income that is subject to the high rate of tax, less eligible dividends previously paid out of the pool.

²These rates reflect the promises made by provincial and federal governments to reduce taxes and participate in the new dividend rules.

if the enhanced capital gains exemption is available.³ After both the CDA and the capital gains exemption have been exhausted, consideration should be given to structuring the arrangement to take advantage of the lowest effective tax rate as between dividends and capital gains.

	Eligible dividends	Capital gains	Difference
British Columbia	18.5%	21.9%	3.4%
Alberta	14.6%	19.5%	4.9%
Saskatchewan	20.4%	22.0%	1.6%
Manitoba	23.8%	23.2%	-0.6%
Ontario	22.4%	23.2%	0.8%
Quebec	29.7%	24.1%	-5.6%
New Brunswick	23.2%	23.5%	0.3%
Nova Scotia	28.4%	24.1%	-4.3%
Prince Edward Island	24.4%	23.7%	-0.7%
Newfoundland & Labrador	28.8%	22.8%	-6.0%

In order to achieve capital gains treatment on a buy-sell arrangement, the criss-cross method or promissory note method could be employed. On the other hand, in order to achieve dividend treatment, the redemption method could be employed. In addition to these two alternatives, planning could entail a hybrid structure that optimizes both strategies in order to achieve the maximum benefits of each structure.

Consider the following example, which focuses on the redemption method:

Allan and Bob are 50/50 shareholders of OpcO, which is worth \$20 million.

The adjusted cost base and paid-up capital of their shares are nominal.

Their retained earnings contain \$6 million of after-tax income taxed at the top corporate rate.

Allan has just recently passed away and the company has received \$8 million of life insurance proceeds.

The shares are not eligible for the enhanced capital gains exemption.

Their buy-sell arrangement can easily be completed because 80 per cent of the obligation is available in the form of life insurance and the other 20 per cent could be paid over a few years from borrowed funds or future profits. With the effective rate of tax on “eligible” dividends being lower than the effective rate of tax on capital gains, the redemption style of buy-sell arrangement was chosen. However, the actual structure employed can result in significantly different tax results.

From a planning point of view, the first decision to consider is whether to use all of the CDA credit or to utilize the so-called “50 per cent solution” in a share redemption strategy. After this CDA question is settled, the next decision is how much of the eligible dividend pool (GRIP) should be allocated to the deceased shareholder’s estate on the deemed dividend resulting from the redemption of his or her shares. These are the decisions to be made:

- (1) Should the maximum amount of the GRIP dividend pool be allocated only to the deceased’s estate because he or she was the first to pass away (maximum GRIP option)?
- (2) Should 50 per cent (i.e., a pro-rate share) of the GRIP dividend pool be allocated because he or she was a 50 per cent shareholder (pro-rated GRIP option)?
- (3) Should none be allocated because the deceased’s estate has already been allocated the benefit of the CDA (0 per cent GRIP option), thus leaving the GRIP available for the surviving shareholder’s future use?
- (4) Should some other variation be used?

The following analyzes the first three questions:

- 1) If the entire \$8 million CDA credit created by the receipt of the life insurance proceeds were elected on the \$10 million of deemed dividend triggered by the redemption of shares, the remainder \$2 million would be taxed in the estate’s hands as a taxable dividend. However, unless grandfathering is available, the stop-loss rules of the Income Tax Act would apply⁴ to the

³Up to the capital gain exemption limit available to the taxpayer

⁴The reduction is the lesser of the capital dividends received on the shares and the capital loss realized in the estate less 50% of the lesser of the capital loss realized in the estate and the capital gain realized on the terminal tax return.

estate and restrict the ability to carry the estate's capital loss back to the deceased's terminal income tax return to only \$7 million. This leaves the terminal tax return with a \$3 million net capital gain with an associated tax liability of about \$660,000 (assuming a marginal tax rate of 44%).

The \$2 million taxable dividend realized in the estate can be elected as an eligible dividend, which comes from the GRIP pool, but such election will depend on how the buy-sell arrangement is structured. The following reviews the outcomes based on the three variations outlined earlier:

- a) (Maximum GRIP option) If the entire \$2 million were elected as an eligible dividend, the estate would be able to minimize its tax in respect of the dividend to \$360,000 (assuming an 18% effective tax rate on eligible dividends).
- b) (50 per cent GRIP option) If the election as eligible were restricted to the deceased shareholder's share of the eligible pool, the entire \$2 million deemed dividend would still qualify for eligible dividend treatment because the deceased shareholder was entitled to \$3 million of the pool of \$6 million. The estate's associated taxes would still be \$360,000.
- c) (0 per cent GRIP option) If none of the \$2 million deemed dividend were elected as an eligible dividend, the higher dividend tax rates would apply resulting in an income tax liability of about \$690,000 (assuming a 31% effective tax rate on ineligible dividends).

2) If the 50 per cent solution were implemented, only \$5 million of the \$8 million CDA credit would be elected as a capital dividend, leaving \$5 million of the deemed dividend to be taxed as an ordinary dividend. The 50 per cent strategy avoids the application of the stop-loss rules and allows a full loss carry back (\$10 million) from the estate to the terminal return. This leaves the terminal tax return with no income tax liability in respect to the shares of the deceased.

The \$5 million taxable dividend realized in the estate can be elected as an eligible dividend, but such

election will depend on how the buy-sell arrangement is structured.

- d) (Maximum GRIP option) If the entire \$5 million were elected as an eligible dividend, the estate would be able to minimize its taxes in respect of the dividend to \$900,000 (again assuming an 18% effective tax rate on eligible dividends).
- e) (50 per cent GRIP option) If the election of the eligible dividend were restricted to the deceased shareholder's share of the eligible pool, only \$3 million of the deemed dividend would qualify for eligible dividend treatment, leaving \$2 million subject to tax as an ineligible dividend. The combined taxes on the two types of dividends would be \$1,160,000.
- f) (0 per cent GRIP option) If none of the \$5 million deemed dividend were elected as an eligible dividend, the higher dividend tax rates would apply resulting in an income tax liability of about \$1,550,000.

The above analysis of the situation resulted in six different scenarios with significantly different income tax results to the deceased shareholder or the estate:

100% CDA election versus 50% solution	Deceased's or estate's portion of the eligible dividend pool	Resulting income tax liability to the deceased or the estate
1	a	1,020,000
1	b	1,020,000
1	c	1,350,000
2	d	900,000
2	e	1,160,000
2	f	1,550,000

Before any firm decisions can be made with respect to how the redemption style of buy-sell arrangement can be structured, the surviving shareholder's position should be reviewed to see how alternatives affect his or her ongoing opportunities. The following chart summarizes the outcome on the remaining shareholder in this particular case.

CDA	Eligible dividend pool	Deceased's tax liability	Remaining CDA for survivor	Remaining eligible dividends for survivor
1	a	1,020,000	0	4,000,000
1	b	1,020,000	0	4,000,000
1	c	1,350,000	0	6,000,000
2	d	900,000	3,000,000	1,000,000
2	e	1,160,000	3,000,000	3,000,000
2	f	1,550,000	3,000,000	6,000,000

In the example given, the executor of the deceased would prefer the 50 per cent solution where the remaining taxable dividend is elected as an eligible dividend because that results in the least amount of tax for the estate to fund. From the survivor's point of view, he or she would be entitled to the remaining \$3 million CDA credit and still have a \$1 million eligible dividend pool.

This is not as favourable for the surviving shareholder as some of the other alternatives presented. This is why the decisions outlined above need to be addressed in the shareholders' agreement – to ensure future disagreements can be minimized or avoided.

As can be seen by this analysis, the structure of a shareholders' agreement can have a significant impact on the deceased shareholder's after-tax position and the position of the surviving shareholder. The shareholders' agreement should contain obligatory buy-sell provisions where the specific structure is left flexible in order to maximize tax planning. However, flexibility might lead to disputes and litigation, and should be restricted to be "fair" to both parties. This suggests that direction must be addressed in the shareholders' agreement.

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