Buy-sell agreements
Planning for incorporated businesses

BUY-SELL AGREEMENTS: PLANNING FOR INCORPORATED BUSINESSES

INTRODUCTION

This is the second of three articles on buy-sell agreements. The first article discusses five of the most common ways to fund a buy-sell agreement at a shareholder's death. It also discusses buy-sell agreements with a surviving spouse, and the stop loss rules. This article discusses different ways to implement a buy-sell agreement for an incorporated business, when each owner owns shares in the operating company. The third article discusses buy-sell agreements when the owners own the business through individually owned holding companies.

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OWNERS OWN OPCO DIRECTLY
BASIC SCENARIO ASSUMPTIONS

- A and B are 50% shareholders of Opco, the operating company that runs their business
- Opco has a fair market value of $2,000,000
- Shareholder A dies
- A's holdings consist of:
    - Fair market value (FMV) of Opco shares = $1,000,000
    - Adjusted cost base (ACB) and paid up capital (PUC) of Opco shares = nil
- $1,000,000 of life insurance on each shareholder funds the buy-sell agreement
- When Opco owns the insurance policy, the policy has an adjusted cost basis of nil for tax purposes at the time of death. Opco can therefore post all the insurance proceeds to its capital dividend account (CDA)
- Personal marginal tax rate on regular income = 50%
- Personal marginal tax rate on dividends = 45% [1]
- Capital gains inclusion rate = 50%
- The stop-loss rules apply

LIFETIME CAPITAL GAINS EXEMPTION

In each example, we assume that the deceased shareholder may reduce any tax arising on the deemed disposition of shares immediately before death by using the lifetime capital gains exemption (LCGE).

[1] This rate assumes that the dividend will be a "non-eligible" dividend rather than an "eligible dividend" that is taxable at a lower rate. Generally, non-eligible dividends, taxed at the higher rate, will originate in corporate income taxed at the reduced rate for small business income.

SPOUSAL ROLLOVER

The examples assume that a buy-sell agreement requiring the remaining shareholders to purchase (or Opco to redeem) the deceased shareholder's shares precludes a tax-deferred rollover of those shares to a surviving spouse or spouse trust under subsection 70(6) of the Income Tax Act (the Act).[2] To qualify for the rollover, the shares must "become vested indefeasibly" in the surviving spouse. That can't happen if the buy-sell agreement requires that the shares be transferred to someone else. However, see the section in our first article, "Buy-sell planning with a surviving spouse—Put-call and capital gains exemption" for alternative planning options.

1. Cross-purchase - Personally owned insurance

In this structure:

1. The buy-sell agreement is between the two owners.
2. Each shareholder owns, pays the premiums, and is the beneficiary of a life insurance policy on the life of the other shareholder. Alternatively:

- Each shareholder owns and pays for the policy on their own life with the other shareholder as beneficiary. An irrevocable beneficiary designation reduces the risk that the policy owner or a creditor will remove policy values intended to fund a buy-sell agreement,[3] but will not ensure that the shareholder continues to pay the premiums or keep the policy in force.

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[2] 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.

[3] See, for example, Insurance Act (Ontario), s. 191(1). Similar provisions appear in the insurance legislation of the other common law provinces and the Civil Code (Quebec), art. 2458.

- A trustee can own the policies on behalf of each shareholder. The trustee ensures that each shareholder contributes their share of the premiums, otherwise keeps the policies in force, and administers the buy-sell agreement according to its terms.[4]

When A dies:

3. B, the surviving shareholder, receives the life insurance proceeds.
4. A's estate sells A's shares to B.
5. B uses the insurance proceeds to pay for the shares.

B now owns all the Opco shares, and A's estate has received FMV in cash for the shares it sold to B.

[4] 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.

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During life

A

Owns 50%

B

Owns 50%

Opco

Owns and pays premiums for policy on B's life

Life insurance company

Owns and pays premiums for policy on A's life

At A's death

A's estate

2. B pays cash for A's shares

B

3. A's estate sells A's shares

4. Owns 100%

Opco

Life insurance company

1. Pays tax-free death benefit

A and B pay premiums for insurance on each other's lives.

1. Insurance company pays B insurance proceeds on A's life.
2. B pays A's estate for Opco shares.
3. A's estate transfers A's Opco shares to B.

TAX CONSEQUENCES

DECEASED SHAREHOLDER (A)

A is deemed to have disposed of the shares to his or her estate for proceeds equal to FMV immediately before death.

Proceeds of disposition for tax purposes	1,000,000
ACB	0
Capital gain	1,000,000
Taxable capital gain (50% inclusion)	500,000
Tax payable (50% rate)	250,000

A'S ESTATE

A's estate is deemed to acquire the shares at an ACB equal to the amount that A was deemed to have disposed of them, $1,000,000. B purchases the shares from A's estate for the same amount. Because the purchase price and ACB for the shares are the same, A's estate has no capital gain, and pays no tax on the transaction.

Proceeds of disposition for tax purposes	1,000,000
ACB	1,000,000
Capital gain	0
Taxable capital gain (50% inclusion)	0
Tax payable (50% rate)	0

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SURVIVING SHAREHOLDER (B)

B acquires the shares at FMV using the life insurance proceeds. Since B pays $1,000,000 for the shares, B's ACB in all their Opco shares, both previously owned and newly acquired, increases by the same amount.

ACB of B's Opco shares after the transaction	1,000,000
ACB of B's Opco shares before the transaction	0
Increase in ACB of shares owned by B	1,000,000
Value of B's business interest after the transaction	2,000,000
Value of B's business interest before transaction	1,000,000
Value purchased from A's estate	1,000,000

Summary

Like the personally owned cross-purchase arrangement, this structure most benefits the surviving shareholder. They use the insurance proceeds, not their own funds, to buy the shares, and obtains an increase in the ACB in all their shares equal to the purchase price.

The deceased shareholder pays the tax in this structure, subject to A's remaining LCGE and any other offsetting deductions.

If Opco retains its current value until B's death, B will have a deemed disposition immediately before death of their Opco shares at FMV ($2,000,000). Since B's ACB in those shares is $1,000,000, B will have a capital gain of $1,000,000. B will report half of that gain on their final tax return. At a 50% tax rate B will pay $250,000 in tax, the same as A paid. B could reduce this tax by using the LCGE to the extent it is still available at B's death.

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2. Cross-purchase—Opco owned insurance

In this structure:

1. The parties to the buy-sell agreement are A, B and Opco.
2. Opco owns and pays the premiums for life insurance policies on each shareholder.
3. Opco is the beneficiary of each policy.

When A dies:

4. Opco receives the life insurance proceeds, and credits all the proceeds to its CDA (as noted above, the adjusted cost basis in the life insurance policy is nil immediately before A's death).
5. A's estate sells A's shares to B.
6. B gives A's estate a demand promissory note in exchange for A's shares.
7. Now that B owns all the shares in Opco, B causes Opco to pay a dividend. Opco also files an election in prescribed form with the Canada Revenue Agency (CRA) to make the dividend a tax-free capital dividend. The remainder of the dividend (if any – this example assumes that the policy's adjusted cost basis is nil so that the entire proceeds of insurance can be posted to Opco's CDA with no reduction) will be taxable.[5]
8. B uses the capital dividend to redeem the promissory note.
9. A's estate cancels and returns the promissory note to B.
10. B now owns all the Opco shares, and A's estate has received FMV in cash for the shares it sold to B.

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[5] The capital dividend election must apply to the whole dividend: subsection 84(2). If the CDA contains insufficient funds to support the capital dividend election, the corporation will be subject to a penalty tax on the excess (subsection 184(2)) unless it elects to treat the excess as a separate and taxable dividend (subsection 184(3)).

Sun Life
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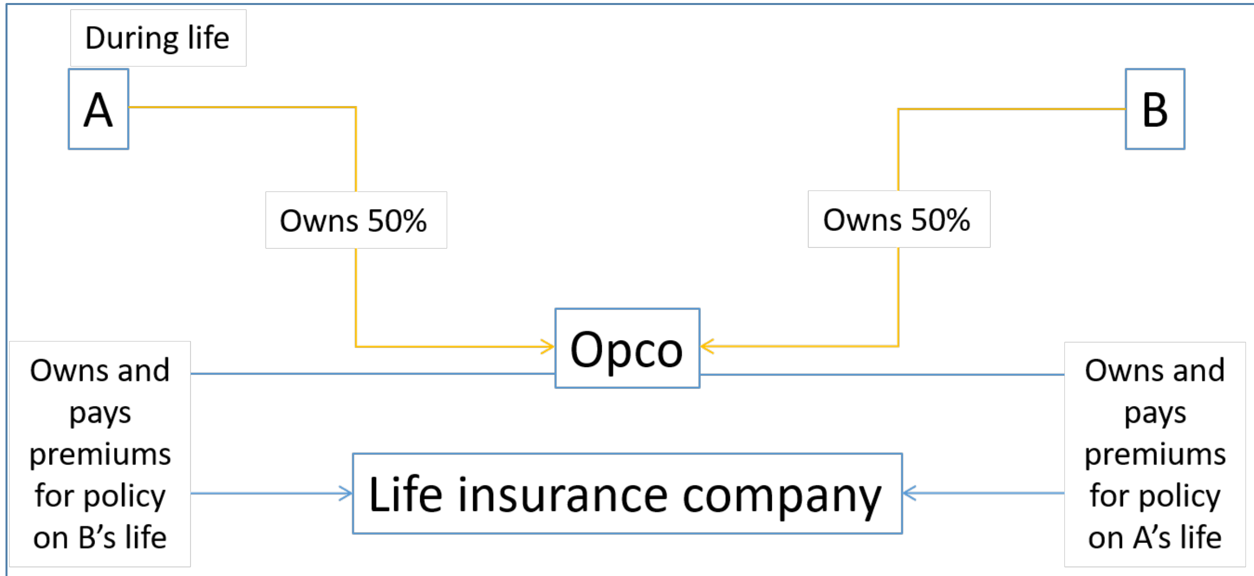
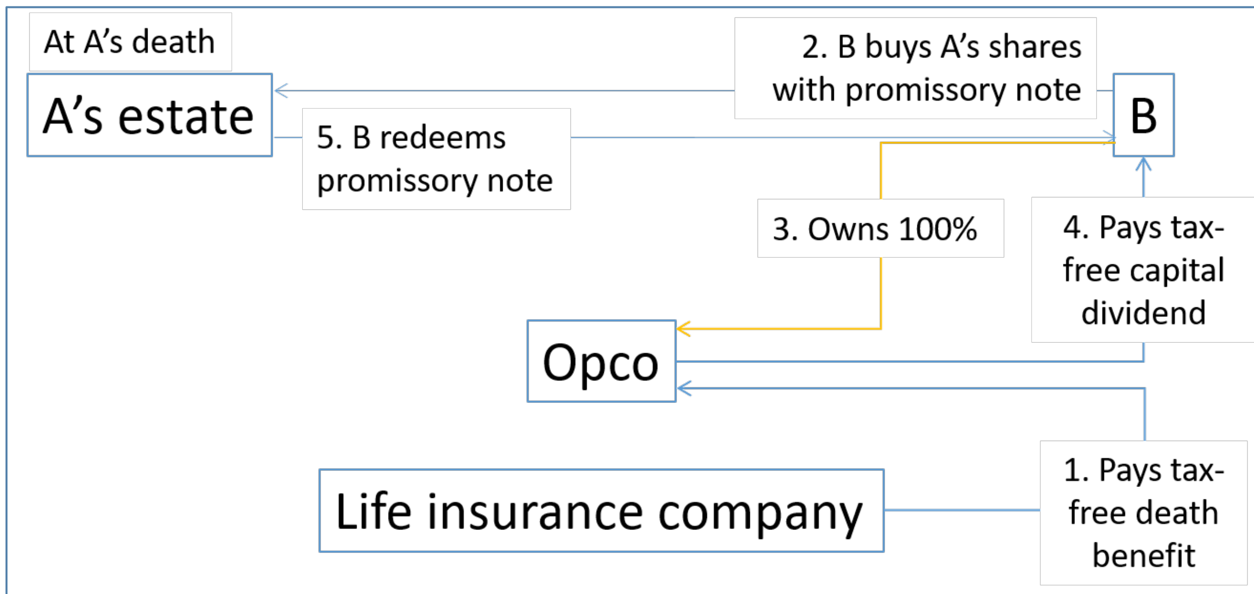

During life
A
B
Owns 50%
Owns 50%
Opco
Owns and pays premiums for policy on B's life
Owns and pays premiums for policy on A's life
Life insurance company


At A's death
A's estate
2. B buys A's shares with promissory note
B
5. B redeems promissory note
3. Owns 100%
4. Pays tax-free capital dividend
Opco
Life insurance company
1. Pays tax-free death benefit

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Opco pays premiums to insure A and B.

1. Insurance company pays Opco insurance proceeds on A's life.
2. B buys A's shares in Opco from A's estate, with a demand promissory note.
3. B becomes Opco's sole shareholder.
4. B causes Opco to pay B a tax-free capital dividend.
5. B pays A's estate to redeem the note.

TAX CONSEQUENCES

The tax consequences of the corporately owned cross-purchase will generally be almost identical to those of the personally owned cross-purchase.

DECEASED SHAREHOLDER (A)

A is deemed to have disposed of the shares for proceeds equal to FMV

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Proceeds of disposition for tax purposes	1,000,000
ACB	0
Capital gain	1,000,000
Taxable capital gain (50% inclusion)	500,000
Tax payable (50% rate)	250,000

ESTATE OF DECEASED SHAREHOLDER (A)

A's estate is deemed to acquire the shares at an ACB equal to the amount that A was deemed to have disposed of them, $1,000,000. B purchases the shares from A's estate for the same amount. Because the purchase price and ACB for the shares are the same, A's estate has no capital gain, and pays no tax on the transaction.

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Proceeds of disposition for tax purposes	1,000,000
ACB	1,000,000
Capital gain	0
Taxable capital gain (50% inclusion)	0
Tax payable (50% rate)	0

SURVIVING SHAREHOLDER (B)

B acquires the shares at FMV using the life insurance proceeds. Since B pays $1,000,000 for the shares, B's ACB in all their Opco shares, both previously owned and newly acquired, increases by the same amount.

To redeem the promissory note paid as consideration for the shares, B causes Opco to pay a $1,000,000 dividend to B. To the extent of the available CDA in Opco created by the life insurance proceeds, Opco can file an election with the CRA to make this a tax-free capital dividend. Any excess over the available CDA would be a taxable dividend.

ACB of B's Opco shares after the transaction	1,000,000
ACB of B's Opco shares before the transaction	0
Increase in ACB of Opco shares owned by B	1,000,000
Value of B's interest in Opco after the transaction	2,000,000
Value of B's interest in Opco before transaction	1,000,000
Value purchased from A's estate	1,000,000
CDA credit remaining after capital dividend election	0

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SUMMARY

Like the personally owned cross-purchase arrangement, this structure most benefits the surviving shareholder. They use the insurance proceeds, not their own funds, to buy the shares, and obtain an increase in the ACB in all their shares equal to the purchase price.

The deceased shareholder pays the tax in this structure, subject to A's remaining LCGE and any other offsetting deductions.

If Opco retains its current value until B's death, B will have a deemed disposition immediately before death of their Opco shares at FMV ($2,000,000). Since B's ACB in those shares is $1,000,000, B will have a capital gain of $1,000,000. B will report half of that gain on their final tax return. At a 50% tax rate B will pay $250,000 in tax, the same as A paid. B could reduce this tax by using the LCGE to the extent it is still available at B's death.

3. Share redemption ("50% solution")—Opco owned insurance

We assume that the following redemption strategies are subject to the 1995 "stop-loss" rules. Those rules limit the amount of a loss created from a share redemption to defer tax that would otherwise arise. See our article, "Buy-sell agreements: funding and basic structures," for more details. Generally, the stop-loss rules let the estate transfer no more than 50% of the loss resulting from a share redemption to the deceased's final tax return when the corporation redeems the shares using a tax-free capital dividend paid from corporate-owned life insurance. Therefore, under this structure the corporation pays the redemption proceeds with a tax-free capital dividend only to the extent of the non-taxable portion of the deceased's capital gain on the disposition of the shares, hence the name for the strategy, the "50% solution".[6]

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[6] Technically, the structures propose funding the redemption of the deceased's shares with life insurance money by using two dividends: a tax-free capital dividend to the extent of the non-taxable portion of the capital gain on the

In this structure:

1. The parties to the buy-sell agreement are A, B and Opco.
2. Opco owns and pays the premiums for life insurance policies on each shareholder.
3. Opco is also the beneficiary.

When A dies:

4. Opco receives the life insurance proceeds and credits the proceeds to its CDA to the extent those proceeds exceed the adjusted cost basis in the policy immediately before A's death.
5. Opco redeems A's shares from A's estate.
6. Opco uses the life insurance proceeds to fund the redemption.
7. B now owns all outstanding Opco shares and therefore 100% of Opco.

In this scenario, the surviving shareholder, B, acquires A's Opco shares without directly paying for them. Instead, A's redeemed shares go to Opco's treasury, after which they will have no further role to play in Opco. B's shares, previously accounting for half of all outstanding Opco shares, and therefore half of Opco's value, now account for all Opco's outstanding shares, and all Opco's value, even though B has the same number of shares after the redemption as before.

If Opco pays a capital dividend equal to 100% of A's deemed capital gain, i.e., without using the 50% solution, the dividend will be entirely tax-free to A's estate. However, the stop-loss rules will prevent A's estate from carrying back half of its capital loss to A's final return. A will therefore pay tax on half the capital gain. With the 50% solution, A's estate will instead pay tax on a dividend in the same amount, but will be able to carry back the entire capital loss to A for A to use on his or her final tax return.

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disposition of the shares (using the CDA, that credits the receipt of tax-free life insurance benefits) and a taxable dividend that provides the balance of the acquisition cost.

In other words, if Opco pays a tax-free capital dividend to the full extent of its CDA created from the life insurance proceeds, without using the 50% solution, the overall tax consequences to A and A's estate will be similar, but B will lose 50% of Opco's CDA for future use. With the 50% solution, Opco will use only 50% of its CDA to obtain the same loss carry-back for A that A would have without using the 50% solution. The rest of Opco's CDA will remain for Opco to pay future tax-free capital dividends when Opco has surplus cash.

IMPLEMENTING THE 50% SOLUTION

Technically, the structures use two dividends to fund the share redemption with life insurance:

1. A tax-free capital dividend to the extent of the non-taxable portion (i.e., 50%) of the capital gain on the disposition of the shares, hence the "50% solution," and
2. A taxable dividend that provides the balance of the acquisition cost.

However, to elect a capital dividend under subsection 83(2) of the Act a corporation must make the election "in respect of the full amount of the dividend."[7] This makes it impossible to split a dividend that arises by operation of the share redemption rules under subsection 84(3) into a tax-exempt capital dividend and a taxable dividend. Nevertheless, a corporation can still split the dividend using other, less direct means.

Simply redeeming the shares in two equal groups, and declaring each to be a taxable and capital dividend respectively, will not circumvent the "entire dividend" requirement. Under subsection 112(3.2) A's estate must compute the stop-loss reduction on a share-by-share basis. Each share redeemed by a capital dividend will therefore be subject to the stop-loss rules, resulting in the "50% solution" becoming the "25% solution".

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[7] Form T2054 "Election for a Capital Dividend" reinforces the restriction by requiring the authorized signing officer of the corporation to certify that the election is for "the full amount of the dividend."

One method to plan around the "entire dividend" requirement for a capital dividend election is to create a deemed dividend using rules that apply to the paid-up capital (PUC) of a corporation ("PUC bump").[8] To simplify, the PUC of a single share, class of shares or all the shares of a corporation originates in the stated capital accounts of a corporation that are required under corporate law.[9] This will ordinarily be the initial consideration that the shareholders pay or contribute to the corporation when it issues new shares. This is assumed to be nominal in the examples presented in this paper and is valued as "nil".

However, where corporate law permits, the corporation may increase the PUC of a class of shares, for example, by adding to the PUC an amount it has credited to its accounts for retained earnings or other surplus of the corporation.[10] When the corporation does so, two tax consequences follow:

1. The corporation is deemed to have paid a dividend to the shareholders of that class of shares equal to the addition to the PUC[11] and
2. To avoid double taxation, the deemed dividend that arises from any redemption of shares of that class does not include its PUC, and therefore does not include the addition to its PUC.[12]

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[8] Subsection 84(1) of the Act. "Paid-up capital" is defined in subsection 89(1) of the Act.

[9] For example, Business Corporations Act (Ontario), R.S.O. 1990, c. B.16, s. 24.

[10] *Ibid.*, subsection 24(5).

[11] Subsection 84(1) of the Act.

[12] Subsection 84(3) of the Act. The PUC reduces the subsection 84(3) deemed dividend to avoid taxation on the return of capital that created PUC on the original issue of the shares and on any corporate surplus subsequently credited to the PUC that is also taxable as a subsection 84(1) deemed dividend.

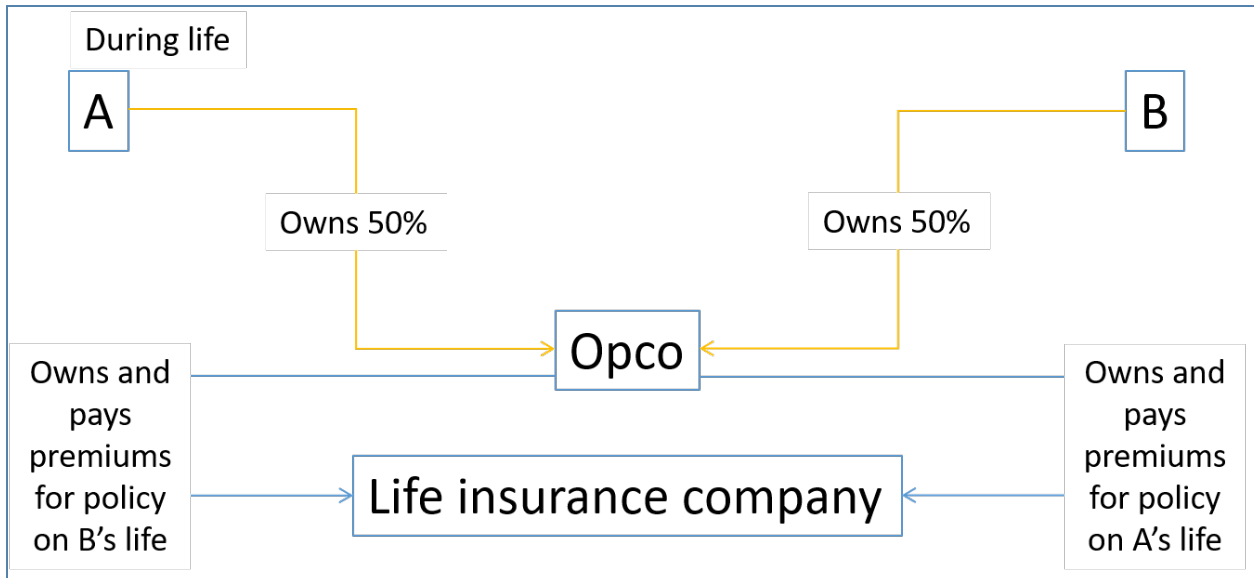
The corporation will be able to elect to treat the dividend that arises from the addition to PUC as a tax-free capital dividend to the extent of its CDA. The result will be two dividends, a tax-free capital dividend created by the increase in PUC and capital dividend election, and a taxable dividend created by redeeming shares.

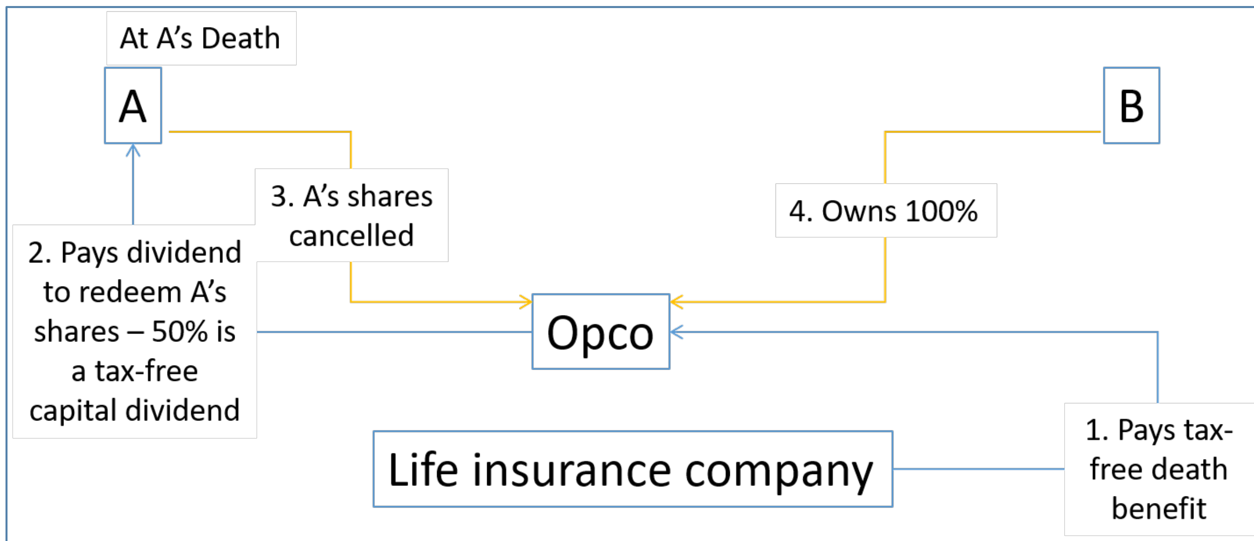
This strategy will require additional refinements and post-mortem planning. First, as a critical prerequisite, the corporation will need retained earnings or other eligible surplus in its accounts before it can increase PUC. Further choices and increasing complexity will depend on the facts of the case. For example, while it is possible to redeem the shares of a single shareholder, a change of PUC will apply to all shares of the same class and it will be necessary to convert A's shares into a separate class if it is desired to restrict the PUC addition and capital dividend election to A's shares. These planning issues, among others, exceed the scope of this paper.

In the present example:

- Opco will increase the PUC of the shares that A's estate owns by $500,000.
- This will result in a deemed dividend to the estate of $500,000, which Opco will elect to make a tax-free capital dividend.
- Opco will redeem A's shares using the life insurance proceeds of $1,000,000.
- This will result in a taxable deemed dividend to the estate of $500,000 (i.e., $1,000,000 proceeds minus $500,000 of PUC).
- Redemption constitutes a disposition of capital property, resulting in a $1,000,000 capital loss which is subject to the stop-loss rules. However, the amount of the reduction in this scenario is nil.
- A's estate carries back the $1,000,000 capital loss to offset the capital gain in A's terminal return.
- $500,000 remains in Opco's CDA for the surviving shareholder, B.

Share redemption – Corporate owned insurance





Opco pays premiums to insure A and B.

1. Insurance company pays Opco insurance proceeds on A's life.
2. Opco redeems its shares from A's estate, paying a deemed dividend, and elects 50% to be a tax-free capital dividend.
3. A's estate transfers Opco shares to Opco for cancellation.
4. B owns 100% of Opco shares.

TAX CONSEQUENCES
DECEASED SHAREHOLDER (A)

A is deemed to have disposed of their shares for fair market value. Subject to the limitations imposed by the stop-loss rules, A's estate can carry back the loss it sustains when Opco redeems its shares to reduce or eliminate A's capital gain (and resulting tax). If Opco limits its use of the CDA to pay a capital dividend equal to the tax-free 50% of A's deemed capital gain, the stop-loss reduction will not apply. A's estate can then elect to carry back the entire redemption proceeds (less PUC of the shares redeemed) as a capital loss to offset the tax on A's capital gain.

Proceeds of disposition for tax purposes	1,000,000
ACB	0
Capital gain	1,000,000
Loss carried back from A's estate	(1,000,000)
Adjusted gain	0
Taxable capital gain (50% inclusion)	0
Tax payable (50% rate)	0

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ESTATE OF DECEASED SHAREHOLDER

The difference between the redemption proceeds and the PUC of the shares redeemed is deemed to be a dividend.[13] In this case, with a nil PUC, all the redemption proceeds will therefore be a deemed dividend. As discussed above, provided the insurance proceeds created a CDA of $1,000,000 or more in Opco, a capital dividend election could be filed, allowing the deemed dividend to be tax-free to the estate. However, planning around the stop-loss rules (i.e., the 50% solution) requires that Opco file a CDA election to declare only $500,000 of the deemed dividend as a tax-free capital dividend.

A's estate simultaneously receives two amounts for tax purposes when Opco redeems its shares:

- A deemed dividend of $1,000,000, half of which is caused to be tax-free using the CDA created by the life insurance. (Note again that only half of the CDA created by the life insurance is used because anything more would create a stop-loss reduction).
- Proceeds of disposition of $1,000,000 for the redemption of the shares. However, its proceeds of disposition ($1,000,000) are reduced by the deemed dividend (also $1,000,000) to nil. Since A's estate has an ACB in those shares of $1,000,000, it sustains a $1,000,000 capital loss on the disposition of the shares.

The capital loss can be carried back and claimed against any capital gains on A's final tax return. The taxable half of the deemed dividend attracts tax of $225,000 at the assumed dividend tax rate of 45%.

[13] Subsection 84(3) of the Act.

Proceeds from share redemption by Opco	1,000,000
Portion deemed to be a dividend	(1,000,000)
Adjusted proceeds for purposes of calculating capital gain for	0
ACB to the estate of the shares	(1,000,000)
Capital loss for the estate	(1,000,000)
Loss "stopped" by the stop-loss rules	0
Revised loss for the estate	(1,000,000)
Portion of proceeds deemed to be a dividend	1,000,000
Capital dividend election	(500,000)
Taxable dividend to the estate	500,000
Tax payable by the estate on taxable dividend (at 45%)	225,000

SURVIVING SHAREHOLDER (B)

In this scenario, the surviving shareholder (B) acquires the potential taxable gain of A. This occurs because the surviving shareholder's interest in the business has increased from 50% to 100% when B became the owner of all Opco's outstanding shares without paying anything for the increase, and without acquiring any more shares. There are no immediate tax consequences to B. However, since B paid nothing for this increase in share value, B's investment in Opco shares receives no increase in its ACB.

ACB of shares after the redemption	0
ACB of shares before the redemption	0
Increase in ACB of shares caused by redemption	0
Value of shares owned after the redemption	2,000,000
Value of shares owned before the redemption	1,000,000
Additional value acquired through the redemption	1,000,000
Potential gain on sale or death after the redemption	2,000,000
Potential gain on sale or death before the redemption	1,000,000
Increase in potential gain acquired through the redemption	1,000,000
CDA credit remaining after capital dividend election	500,000

SUMMARY

In this structure, B acquires the latent gain in A's Opco shares without any out-of-pocket payment.

By using the "50% solution" and limiting its election of a tax-free capital dividend to the 50% tax-free portion of the capital gain on the deemed disposition of A's shares, Opco retains a $500,000 credit in its CDA that it can use for future elections of a tax-free capital dividend when cash is available. That is the key benefit of the 50% solution.

4. **Hybrid of cross-purchase and redemption ("50% solution")—Opco owned insurance**

In this structure, we assume that A has $500,000 remaining in the LCGE A can use to offset some of the capital gain on the deemed disposition of A's Opco shares immediately before death:

1. The parties to the buy-sell agreement are A, B and Opco.
2. Opco owns and pays the premiums for life insurance policies on each shareholder.
3. Opco is also the beneficiary.

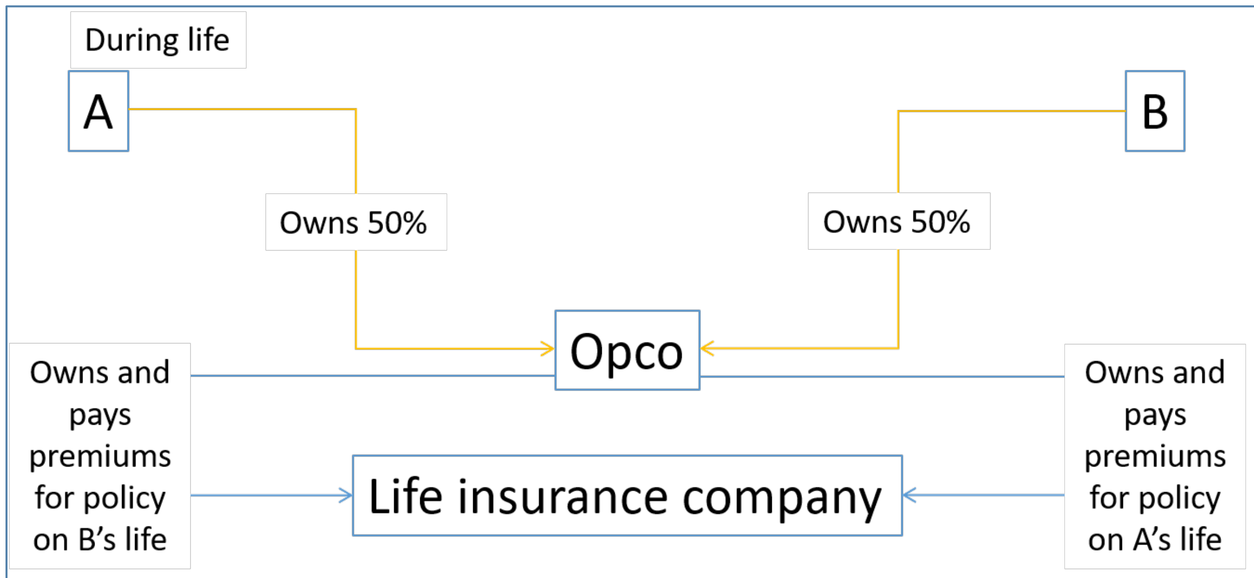
When A dies:

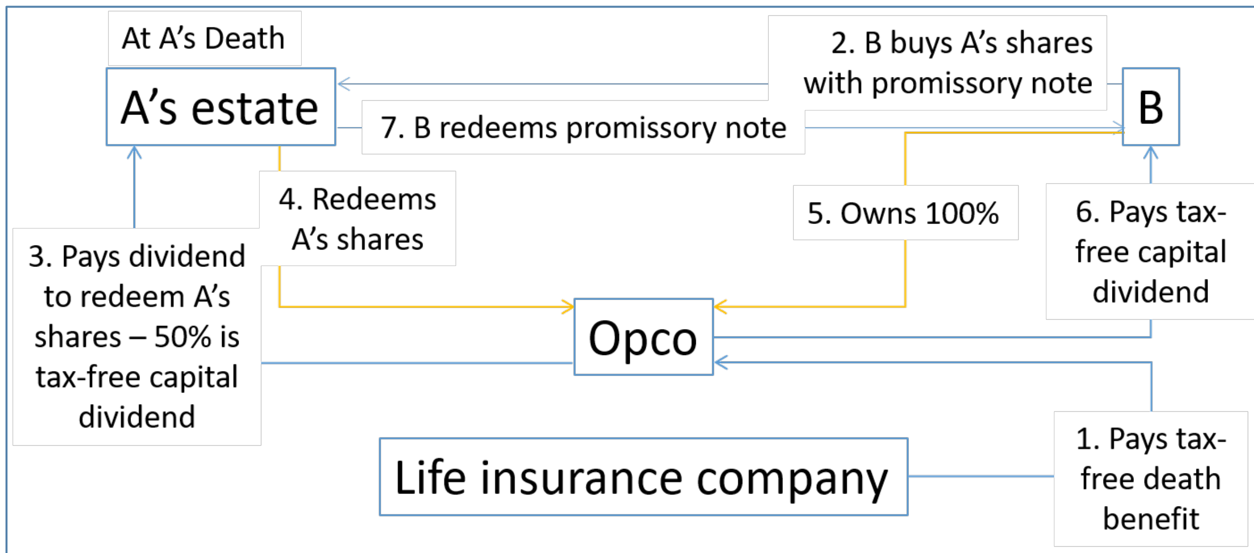
4. Opco receives the life insurance proceeds ($1,000,000).
5. A's estate sells enough of A's shares to B to exactly use up A's remaining LCGE, $500,000. In this example, we assume that that amount is half of A's shares.
6. B pays for the shares with a demand promissory note.
7. Opco redeems A's remaining shares from A's estate.
8. Opco uses the life insurance proceeds to fund the redemption.
9. Opco files an election to deem the dividend to be in part a tax-free capital dividend. The amount of the tax-free dividend depends on two limiting factors:
    - An amount permitted to the extent of Opco's CDA (here created by the life insurance proceeds) and
    - An amount that will not cause the stop-loss rules to reduce the capital loss claimed by A's estate on the share redemption. The remainder of the dividend will be taxable.
10. Now that B owns all the Opco shares, B causes Opco to pay a dividend to B. B uses the proceeds of the dividend to redeem the promissory note.
11. A's estate cancels the promissory note.

B now owns all of Opco, and A's estate has received FMV in cash for A's shares.

The benefit of this structure is the ability to sell shares directly to the extent of A's capital gains exemption or other deductions, while deferring the remainder of the capital gains tax until B's death or sale of shares. This is illustrated in the following diagram.

Hybrid of cross-purchase and redemption (50% solution) – Opco owned insurance





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Opco pays premiums to insure A and B.

1. Insurance company pays Opco insurance proceeds on A's life.
2. B pays A's estate for enough Opco shares to use the remainder of A's LCGE, with a demand promissory note.
3. Opco redeems the remaining Opco shares from A's estate, paying a deemed dividend, and elects 50% to be a tax-free capital dividend.
4. A's estate transfers the redeemed Opco shares to Opco for cancellation.
5. B now owns all the Opco shares.
6. B causes Opco to pay B a tax-free capital dividend sufficient to redeem B's promissory note.
7. B pays A's estate to redeem the note.

TAX CONSEQUENCES
DECEASED SHAREHOLDER (A)

A is deemed to have disposed of the Opco shares for fair market value, $1,000,000. The example assumes that A had $500,000 of the LCGE remaining at the time of death, so that the tax payable on $500,000 of the capital gain will be $0. As discussed below, subject to the limitations imposed by the stop-loss rules, the loss incurred by A's estate when Opco redeems a portion of the shares (in this case, half) can be carried back to eliminate the remaining half of the capital gain (and resulting tax) on A's final tax return.

Proceeds of disposition for tax purposes for all shares	1,000,000
ACB	0
Capital gain	1,000,000
Loss carried back from A's estate	(500,000)
Capital gain subject to tax	500,000
Taxable capital gain (50% inclusion)	250,000
Capital gains deduction[14] (50% of available capital gains exemption)	(250,000)
Taxable income amount	0
Tax payable (50% rate, using the capital gains exemption)	0
Tax payable (50% rate, without the capital gains exemption)	125,000

ESTATE OF DECEASED SHAREHOLDER

In this example, A's estate will sell half the Opco shares to B. Opco will redeem the other half. A's estate receives total proceeds of $1,000,000. For tax purposes, these proceeds are reduced by the redemption amount portion, which is also deemed to be a dividend ($500,000). The net proceeds, when compared to the estate's ACB in the shares (the same $1,000,000 at which A was deemed to have disposed of them at death), create a $500,000 loss. A's estate can carry this loss back to A to reduce the gain on A's final tax return.

The difference between the redemption proceeds and the PUC of the $500,000 of shares that are redeemed, rather than sold, is deemed to be a dividend. In this case, with a nil PUC, all the redemption proceeds will therefore be a deemed dividend.

[14] The lifetime capital gains exemption is utilized by claiming a capital gains deduction at a 50% rate that offsets the 50% inclusion rate for taxable capital gains: subsection 110.6(2.1) of the Act.

As discussed above, provided the insurance proceeds created a CDA of $500,000 or more in Opco, a capital dividend election could be filed, allowing the deemed dividend to be tax-free to the estate. However, the stop-loss rules cause Opco to elect that only 50% ($250,000) of the redemption proceeds are a tax-free capital dividend. Consequently, the remaining proceeds are a taxable dividend and attract a tax on dividends of 45% or $112,500. Opco retains $750,000 in its CDA.

Proceeds received by A's estate on sale and redemption of all shares	1,000,000
Portion deemed to be a dividend	(500,000)
Adjusted proceeds for purposes of calculating capital gain for estate	500,000
ACB to the estate of the shares[15]	(1,000,000)
Capital loss for the estate	(500,000)
Loss "stopped" by the stop-loss rules	0
Revised loss for the estate	(500,000)
Proceeds of $500,000 of shares redeemed (deemed dividend)	500,000
Capital dividend election	(250,000)
Taxable dividend to estate	250,000
Tax payable by estate on taxable dividend (45% rate)	112,500

The estate therefore has a tax-free dividend and a capital loss of $500,000. The capital loss can be carried back and claimed against any capital gains on A's final tax return. But A's estate also must pay $112,500 tax on the taxable portion of the deemed dividend.

[15] Deemed to equal the deemed proceeds of disposition for the deceased shareholder, subsection 70(5) of the Act.

SURVIVING SHAREHOLDER (B)

In this scenario, B's interest in the business has increased by $1,000,000 with B paying for only half of the increase ($500,000 share purchase), not the other half ($500,000 share redemption). There are no immediate tax consequences to B on the redemption of shares.

However, since B paid for only half of this increase in share value, B's increase in the ACB of their overall investment in Opco shares rises only by the purchase price, $500,000. B therefore acquires half of the potential taxable gain of A. At the same time, B acquires access to the remaining CDA in Opco, $750,000, which Opco may use in future to declare tax-free capital dividends when there is a qualifying corporate surplus.

ACB of shares before transaction	0
Increase in ACB from direct purchase from estate	500,000
Increase in ACB of shares caused by redemption	0
ACB of shares after transaction	500,000
Value of B's shares before the redemption	1,000,000
Additional value purchased directly from A's estate	500,000
Additional value acquired after the redemption	500,000
Total value of B's shares after the transaction	2,000,000
Potential gain on sale or death before the transaction	1,000,000
Potential gain on sale or death after the transaction	1,500,000
Increase in potential gain acquired from A	500,000
CDA credit remaining after capital dividend election	750,000

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SUMMARY

In this structure, A and B share in the tax cost, if any. However, B defers any tax they may pay until death or sale of the shares. A incurs tax liability directly on the shares sold, which is reduced by the availability of the LCGE that underlies this structure.

B acquires some of the latent gain that existed in A's shares, through the share redemption portion of the transaction. On the other hand, B has acquired the value of A's redeemed shares without any out-of-pocket payment together with Opco's remaining CDA, which can be used to pay a tax-free capital dividend when qualifying corporate surplus becomes available.

COMPARING THE FOUR STRATEGIES

The following tables compare the results from the four strategies for each of the relevant parties.

	Personally owned	Corporate owned		
	Cross- purchase	Cross- purchase	Redemption (50% solution)	Hybrid (50% cross-purchase/50% redemption)
A (deceased shareholder)				
Deemed proceeds for tax purposes	1,000,000	1,000,000	1,000,000	1,000,000
ACB	0	0	0	0
Capital gain	1,000,000	1,000,000	1,000,000	1,000,000
Loss carryback from the estate	0	0	(1,000,000)	(500,000)
Adjusted capital gain	1,000,000	1,000,000	0	500,000
Taxable capital gain (50%)	500,000	500,000	0	250,000
Capital gains exemption (50%)	n/a	n/a	n/a	(250,000)
Taxable income amount	500,000	500,000	0	0
Tax payable (50% rate, before using any capital gains exemption)	250,000	250,000	0	n/a
Tax payable (50% rate, after using any capital gains exemption)	n/a	n/a	n/a	0

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A's Estate				
Proceeds received	1,000,000	1,000,000	1,000,000	1,000,000
Less: portion deemed to be a dividend	0	0	(1,000,000)	(500,000)
Adjusted proceeds	1,000,000	1,000,000	0	500,000
Less: ACB of shares to estate	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)
Capital loss for the estate	0	0	(1,000,000)	(500,000)
Loss "stopped" by stop-loss rules	n/a	n/a	0	0
Revised loss for the estate	0	0	(1,000,000)	(500,000)
Proceeds of redemption less PUC	n/a	n/a	1,000,000	500,000
Capital dividend election	n/a	n/a	(500,000)	(250,000)
Taxable dividend to estate	n/a	n/a	500,000	250,000
Tax payable (45% rate)	0	0	225,000	112,500

B				
ACB of B's shares after	1,000,000	1,000,000	0	500,000
ACB of B's shares before	0	0	0	0
ACB of new shares/value acquired	1,000,000	1,000,000	0	500,000
Value of B's shares after	2,000,000	2,000,000	2,000,000	2,000,000
Value of B's shares before	1,000,000	1,000,000	1,000,000	1,000,000
Value acquired in the transaction	1,000,000	1,000,000	1,000,000	1,000,000
Potential gain after transaction	1,000,000	1,000,000	2,000,000	1,500,000
Potential gain before transaction	1,000,000	1,000,000	1,000,000	1,000,000
Increase in potential gain acquired	0	0	1,000,000	500,000

	Personally owned	Corporate owned		
	Cross- purchase	Cross- purchase	Redemption (50% solution)	Hybrid (50% cross-purchase/50% redemption)
Combined taxes				
Tax payable by A and A's estate	250,000	250,000	225,000	112,500[16]
Tax payable by B	0	0	0	0
Total tax payable at time of death	250,000	250,000	225,000	112,500
Remaining capital dividend	n/a	0	500,000	750,000

SUMMARY

The redemption method potentially creates a lower overall immediate tax burden than a cross-purchase if no capital gains exemption is available. However, the stop-loss rules have eroded this advantage. In this example, the stop-loss rules have effectively created $225,000 in tax that otherwise would not have been due on a full redemption. As a result of this, the balance may shift towards cross-purchases and away from share redemptions in insured buy-sells at death. This will particularly be the case where the shareholders have remaining LCGE room.

By using the redemption method, B acquires control of $500,000 of Opco's remaining CDA that B can use to take future tax-free dividends once corporate cash flow becomes available. If B expected to use this benefit soon after A's death, it could tilt the balance towards a share redemption.

[16] Using A's LCGE. Without the LCGE, combined tax for A and A's estate is $237,500, reflecting an additional $125,000 in tax on half of A's $500,000 capital gain at 50%.

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Note that, as would be expected, the hybrid method produces a total immediate tax cost ($237,500, before using A's lifetime capital gains exemption) that falls between the results of its two components: less than under a cross-purchase ($250,000) but more than under a share redemption ($225,000).

Again, business owners would most likely consider a hybrid arrangement when the shareholders had sufficient remaining LCGE room to eliminate the tax on the deemed disposition at death. In the present example, A's remaining $500,000 LCGE was exactly enough to cancel the $125,000 tax liability on the disposition of A's shares (deemed disposition of $1,000,000 less $0 ACB less $500,000 loss carryback from A's estate). The hybrid method resulted in A's estate paying only $112,500 in tax.

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