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BUY-SELL AGREEMENTS – CORPORATE-OWNED LIFE INSURANCE

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on important tax changes regarding the stop-loss rules as they relate to buy-sell agreements. Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.

A. BACKGROUND

The provisions of the Income Tax Act (Canada) (the "Act") regarding the stop-loss rules have a significant impact on the structuring of life insured corporate buy-sell arrangements for private companies.

A shareholder agreement can contain buy-sell provisions setting out what would happen in the event of a shareholder's death: the surviving shareholders may be required to buy out the deceased shareholder's interest, and the estate may be required to sell its shares to the surviving shareholders or the corporation.

Life insurance can be used as a method of financing buy-sell arrangements, since the surviving shareholders may not otherwise have sufficient liquid funds to complete the transaction. The buy-sell agreement should also address the issue of the buy-out price.

Another matter that should be considered is who should fund the insurance premiums. Since premiums are generally not tax deductible and are therefore paid from after-tax funds, it may be beneficial to have the corporation pay the premiums from funds taxed at the lower corporate rate.

B. REVIEW OF RULES REGARDING TAXATION ON DEATH

1. Pursuant to the Act, there is a deemed disposition immediately prior to death of each non-depreciable capital property (including shares) owned by the taxpayer at that time for proceeds of disposition equal to the fair market value of the property. Where there is a capital gain on death, the taxpayer's executor may elect to post security and pay the resulting tax in up to 10 equal consecutive annual installments.

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2. In the event that capital property is bequeathed to a spouse or to a testamentary spouse trust, the deemed disposition rules will not apply and a tax deferral may be available. In the event that the estate has unused losses or the deceased taxpayer has an unused portion of the capital gains exemption, or the property of the estate has a fair market value which is less than the original cost to the deceased, then the legal representatives of the deceased may elect in the terminal return not to have the spousal roll-over apply to any property in order to trigger a capital gain on that property.

3. The above-noted spousal roll-over is only available where the property vests indefeasibly in the spouse or spouse trust no later than 36 months after the taxpayer's death. The Department of Finance considers that a property has vested indefeasibly in a spouse of the testator when the spouse obtains a right to absolute ownership of that property in such a manner that such right cannot be defeated by any future event, regardless that the spouse may not be entitled to the immediate enjoyment of all the benefits arising from that right.

4. Where the deceased taxpayer owned shares in a corporation immediately before death and bequeathed such shares to a beneficiary and the shares are subject to a buy-sell agreement, the question as to whether the shares have vested indefeasibly in the beneficiary would depend on the provisions of the particular buy-sell agreement. Similarly, assuming that a spousal roll-over is not available on death, the tax ramifications to the estate will vary depending on the terms of the buy-sell agreement.

5. Where the shares owned by the estate are purchased for cancellation by the corporation, there is a deemed dividend equal to the difference between the redemption price and the paid-up capital of the shares. Assuming that this deemed dividend is not subject to an election to be treated as a capital dividend, it would be treated as a taxable dividend subject to a dividend tax credit. In order to determine any gain or loss on the disposition of the shares, the amount of the deemed dividend would be excluded from the proceeds of disposition. Where the adjusted cost base of the shares exceeds the proceeds of disposition (net of the deemed dividend), a capital loss or a business investment loss may arise.

6. Where the deemed dividend is subject to an election to be treated as a capital dividend (i.e. arising from the proceeds of a corporate-owned life insurance policy), the tax consequences will depend on whether there is a tax free spousal roll-over of the shares or a capital gain is triggered on the shares on death. Pursuant to subsection 112(3) of the Act, if a capital gain is realized on the shares on death, the estate is precluded from incurring a capital loss pursuant to subsection 164(6) of the Act equal to

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100% of the capital gain on death in order to offset the capital gain on the shares. As a result, the estate is taxable on 50% of the capital gain on death realized on the deemed disposition of the shares.

C. THE LOSS CARRYBACK RULES

1. Pursuant to subsection 164(6) of the Act, where the legal representative has, within the first taxation year of the estate, disposed of capital property of the estate in the course of administering the estate of the deceased taxpayer so that a net capital loss arises, and the legal representative has filed an election, the capital loss will be deemed to be incurred and will be deductible in the year of death. To avoid duplication, where such an election is made, the capital loss is deemed not to be a loss to the estate.

2. Such an election is made by filing an amended return for the year of death of the taxpayer. The election can extend to all or part of such losses; however, no part of such losses may be deducted for a taxation year preceding the year in which the taxpayer died.

3. The application of the election pursuant to subsection 164(6) of the Act, depending upon the date of the buy-sell arrangement, will determine if an estate is taxable, not taxable or taxable on a lesser amount.

4. In particular, unless the grandfathering rules apply, subsection 112(3) of the Act will decrease the capital loss arising on the purchase for cancellation of shares which previously had been subject to the deemed disposition on death, if a capital dividend arises. This will reduce the amount of the capital loss eligible to be carried back pursuant to the election set out in subsection 164(6) of the Act from 100% of the capital loss to only 50% of the capital loss.

D. GRANDFATHERING RULES

1. Transitional rules allow an individual’s estate to use the election under subsection 164(6) of the Act with respect to 100% of the capital loss arising from the disposition of shares owned by an individual or a trust of which the individual is a beneficiary on April 26,1995 in the following cases:

   (a) the disposition occurs after April 26, 1995 pursuant to an agreement in writing entered into before April 27, 1995;

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(b) (i) the disposition is made to the corporation after the individual's death (or, where the individual is a testamentary or inter vivos spouse trust, after the death of the beneficiary spouse); (ii) on April 26, 1995 the corporation was a beneficiary of a life insurance policy on the life of the individual (or, where the individual is a spouse trust, on the life of the beneficiary spouse); and (iii) it is reasonable to conclude that the main purpose of the proceeds of the insurance policy was to fund, directly or indirectly, in whole or in part, the redemption, acquisition or cancellation of the shares by the corporation that issued the shares; or

(c) the disposition occurs after the individual's death (or, where the individual is a testamentary or inter vivos spouse trust, after the death of the beneficiary spouse) and before 1997.

2. The transitional rules contain the following provisions:

(a) the disposition of the shares may be grandfathered where such disposition is made by the taxpayer whose life was insured, the taxpayer's spouse or their estates; and

(b) a share acquired in exchange for another share in a transaction pursuant to section 51, 85, 86 or 87 of the Act, will be considered to be the same share as the exchanged share and may therefore benefit from the grandfathering rules.

E. ADDITIONAL PROVISIONS RELATING TO THE STOP-LOSS RULES

1. Additional provisions relating to the stop-loss rules are set out below:

(a) capital dividends will decrease an individual's capital loss on the disposition of shares only to the extent that the capital loss exceeds the total amount of taxable dividends previously received by the individual on those shares prior to their disposition. As a result, it will be necessary to keep records of the total capital dividends and taxable dividends paid by the corporation to a shareholder;

(b) if the estate of an individual disposes of shares acquired by it on the individual's death, any capital loss arising from the disposition, and deemed by subsection 164(6) of the Act to be a loss of the individual for the taxation year in which the individual died, will be reduced only to the extent that the capital dividend received by the estate on the shares

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exceeds ½ of the lesser of (i) the individual's capital gain arising under subsection 70(5) of the Act with respect to the shares, and (ii) the estate's capital loss otherwise determined; and

(c) a similar limitation as set out in subparagraph (b) above applies to the reduction of the capital loss realized by a spouse trust that disposes of shares after the death of the trust's beneficiary spouse, such that the trust will effectively be taxable on ½ of the taxable capital gain arising on death.

F. CORPORATE FUNDING OF LIFE INSURANCE PREMIUMS

1. An advantage of corporate ownership of the life insurance is that the premiums can be funded by the corporation at the corporation tax level instead of having the insured individual personally fund the premiums from after-tax dollars derived from salary or a bonus.

2. In the event that the insured individual personally funds the premiums, the individual would pay premiums with funds taxed at the top marginal rate of approximately 46%.

3. If, instead, the corporation funds the premiums, the corporation would be paying premiums with funds taxed at much lower rates of between approximately 19% and 36%.

4. It may be possible to structure the payment of premiums by the corporation as a business deduction in the event that life insurance is required as a condition for the granting of a loan to the corporation by a restricted financial institution. The deduction of the insurance premiums would be permitted where the corporation has borrowed funds in order to earn income from a business or property pursuant to the provisions of paragraph 20(1)(e.2) of the Act. In order to have the insurance premiums treated as a deductible expense, it is advisable for the corporation to obtain a written document from the financial institution requesting the insurance policy as a condition for the corporation to obtain the loan. Generally this type of written request by the financial institution will satisfy the Canada Revenue Agency in the event of an audit that the insurance premiums ought to be treated as a deductible expense.

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G. IMPACT OF STOP-LOSS RULES

1. As a result of the reduction of the inclusion rate of a taxable capital gain to 50%, corporate-owned life insurance has become much more beneficial due to the reduced impact of capital gains tax that is triggered on the death of a shareholder, in cases where the shares are left to an individual other than the spouse.

2. An example of the impact of the stop-loss rules is set out in Appendix "A" to this Legal Business Report.

3. Appendix "A" assumes that there is no spousal roll-over on the death of the individual.

4. Appendix "A" assumes that virtually all of the proceeds of a $1,000,000 corporate-owned life insurance policy are distributed as a tax-free capital dividend by the corporation on the redemption of the shares owned by the estate of the deceased.

5. By using the corporate-owned life insurance to fund the buy-sell agreement on death, the effective tax rate on a $1,000,000 capital gain realized by the deceased on death is reduced from the top marginal rate of 23% to approximately 11½%.

6. An advantage of corporate ownership of the life insurance is that the premiums can be funded by the corporation at the corporation tax level instead of having the insured individual personally fund the premiums from after-tax dollars derived from salary or a bonus.

7. In the event that life insurance is required as a condition for the granting of a loan to the corporation by a restricted financial institution, the deduction of the insurance premiums would be permitted where the corporation has borrowed funds in order to earn income from a business or property pursuant to the provisions of paragraph 20(1)(e.2) of the Act.

H. THE 50% SOLUTION

1. Under the 50% solution, corporate-owned life insurance is used to fund the redemption of shares held by a deceased shareholder in circumstances where grandfathering under the stop-loss rules is not available.

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2. The stop-loss rules reduce the amount of the capital loss realized by the estate only in the amount by which a capital dividend exceeds 50% of the lesser of (i) the capital gain resulting from the deemed disposition on death of the shares of the deceased shareholder and (ii) the capital loss in the estate as determined without reference to the stop-loss rules.

3. In the 50% solution, the proceeds from the corporate-owned life insurance are used to fund the redemption of shares held by the estate of the deceased shareholder. The Corporation files an election pursuant to subsection 83(2) of the Act to treat 50% of the resulting deemed dividend as a capital dividend, and the remaining 50% of the redemption amount is treated as a taxable dividend pursuant to subsection 84(3) of the Act.

4. As demonstrated in Appendix "A", the 50% solution results in a total tax payable by the deceased shareholder and his estate of $155,000, on a $1,000,000 deemed disposition of shares on death. This is significantly less than the $230,000 tax which would have been payable had the deceased shareholder merely sold his shares to the surviving shareholder and realized a $1,000,000 capital gain which was not eligible to receive the benefit of the lifetime capital gains exemption.

5. As only 50% of the Corporation's capital dividend account from the proceeds of life insurance was utilized in the redemption of the deceased shareholder's shares, a credit of the remaining 50% of the proceeds of life insurance remains in the capital dividend account. This benefits the surviving shareholder who may receive tax-free capital dividends out of future business earnings of the Corporation.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

APPENDIX "A"

TAX CONSEQUENCES TO DECEASED	100% Solution	50% Solution
Amount of deemed disposition of shares on death	$1,000,000	$1,000,000
Adjusted cost base of shares	0	0
Capital gain realized	1,000,000	1,000,000
Application of capital loss carryback from estate (as per calculation below)	(250,000)	(1,000,000)
Net taxable gain realized	250,000	0
Tax Payable at top marginal rate of 46%	**$115,000**	**0**
TAX CONSEQUENCES TO ESTATE		
(1) DEEMED DIVIDEND		
Proceeds of redemption of shares	$1,000,000	$1,000,000
Stated capital amount of shares	0	0
Amount of deemed dividend	**1,000,000**	**1,000,000**
Capital portion of dividend	1,000,000	500,000
Taxable portion of dividend	0	500,000
Tax on taxable dividend at 31% rate	**0**	**155,000**
(2) CAPITAL LOSS		
Proceeds of disposition of shares	1,000,000	1,000,000
Deduct deemed dividend	1,000,000	1,000,000
Net proceeds of disposition of shares	0	0
Deduct adjusted cost base of shares	(1,000,000)	(1,000,000)
Amount of capital loss otherwise calculated	(1,000,000)	(1,000,000)
Amount of stop loss limitation	500,000	0
Capital loss carried back against deceased's capital gain	(500,000)	(1,000,000)
Total Tax Payable by Deceased and Estate	**$115,000**	**$155,000**

TAX CONSEQUENCES TO SURVIVING SHAREHOLDER

Increase in adjusted cost base of shares	0	0
Amount remaining in capital dividend account	0	$500,000