Buy/Sell agreements – The share redemption method

A buy/sell agreement is an important part of financial planning for business owners, whether they're partners or shareholders. A buy/sell agreement simplifies the succession of the business. It ensures a buyer is available to purchase the business interest of a co-owner when a specific event occurs. It's advisable co-owners establish a buy/sell agreement specifying how an ownership interest of a co-owner will be transferred and what triggering events will give rise to the ability or obligation to transfer that ownership interest.

Funding a buy/sell agreement

Once the buy/sell agreement is established, the next step is to ensure funding is available to fulfill the obligation under the agreement. While there are different methods used to arrange funding, insurance is often the most cost-effective, simplest and safest method.

To arrange funding to meet the buy/sell obligation at death, a life insurance policy is purchased on the life of each co-owner. To fund the buy/sell obligation arising from a critical illness or disability of a co-owner, a critical illness or disability insurance policy is purchased.

The focus of this article is the buy/sell obligation at death, and as such, the discussion below applies to life insurance.

Structure of an insurance policy

Once it's decided to buy life insurance to fund the buy/sell obligation, the next consideration is to determine the structure (e.g., who is the owner, who pays the insurance premium, and who receives the death benefit). Generally, one of the following four types of buy/sell structures is used:

1. Crisscross method
2. Promissory note method
3. Share redemption method
4. Hybrid method, referring to a combination of #2 and #3

In this article, we discuss the share redemption method.

Share redemption method

Under this method, upon the death of a shareholder, the corporation is obligated to buy back (i.e., redeem) the shares of the deceased shareholder, and the estate of the deceased shareholder is obligated to sell the shares to the corporation.

To arrange the funding for the buy/sell agreement, each shareholder is insured separately and each policy is corporately owned. This means the corporation pays the premiums and is the beneficiary.

In the event a shareholder dies, the corporation collects the insurance proceeds from the insurer. Using the insurance proceeds, the corporation buys back the shares of the deceased shareholder from his or her estate.

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Income tax implications

When insurance policies are purchased

There are no income tax implications to the corporation or shareholders when the insurance policies are purchased. However, since the insurance premium is generally considered a non-deductible expense for tax purposes, the corporation pays the premium using after-tax dollars.

When a death occurs

Taxpayers are deemed to have disposed of their assets at fair market value immediately before death. The ownership interest in the business (i.e., shares of the corporation) is one of those assets. Based on the difference between the fair market value and adjusted cost base of the shares, the deceased shareholder would realize either a capital gain or loss.

If the shares are of a qualified small business corporation (QSBC shares), the executor of deceased's estate may be able to claim the available portion of deceased's lifetime capital gains exemption[1] to shelter some or all of the capital gains realized by the deemed disposition of the shares on the terminal tax return.

The estate of the deceased shareholder is deemed to have acquired the shares at this same fair market value.

When the insurance benefit is received

Upon the death of the insured, the death benefit from an exempt life insurance policy is paid tax-free to the beneficiary corporation. Generally, in the case of a private corporation, the excess of the life insurance proceeds over the adjusted cost basis of the policy is added to its capital dividend account.

A tax-free capital dividend can be declared by the corporation to its shareholder(s) to the extent a balance is available in the capital dividend account.

When shares are redeemed

There are two separate transactions to be reported for income tax purposes.

First, when the shares are redeemed, the estate is deemed to have received a dividend to the extent the redemption proceeds exceed the paid-up capital of the shares. For private corporations, often the paid-up capital of the shares is a nominal amount, so most of the redemption proceeds will give rise to dividend income to the shareholder (i.e., the estate in this case). This dividend, unless elected to be paid as a capital dividend (if available) by the corporation, is considered a taxable dividend.

To the extent a positive balance is available in the private corporation's capital dividend account, the corporation may designate the dividend income that the estate is deemed to have received on redemption as a tax-free capital dividend. No tax would be payable by an estate on the portion of the deemed dividend designated as a capital dividend.

Second, because the shares have been sold or disposed of, the disposition of the shares must be reported for tax purposes. The disposition may give rise to a capital gain or loss. In most cases, the fair market value of the shares at the death of the shareholder will be greater than the shares' nominal paid-up capital. This means that the deceased's estate is more likely to realize a capital loss when its shares are redeemed.

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[1] Maximum $892,218 for 2021, and indexed thereafter

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If the share redemption occurs within the first year of the estate, any capital loss realized by the estate can be carried back to the terminal tax return of the deceased shareholder[2]. The capital loss carried back can be used to reduce the capital gain reported on the deceased's terminal tax return, and therefore, recovers a portion of the deceased's final income tax. However, this loss carry back may be subject to certain rules provided in the *Income Tax Act*, generally referred to as stop-loss rules. The stop-loss rules apply to certain share dispositions after April 26, 1995, unless grandfathering rules apply to the disposition.

Stop-loss rules

Stop-loss rules reduce the amount of capital loss, realized on the share redemption, which can be carried back from the estate to the deceased's terminal tax return.

The amount of this loss reduction depends on the capital dividends received by the estate. The formula below calculates the amount of this reduction as equal to the amount by which the:

Lesser of:

- The capital dividend received on the shares by the estate
- The amount of the loss otherwise determined less the taxable dividends received by the estate on the redemption of the shares

Exceeds 50 per cent of the lesser of:

- The amount of loss otherwise determined
- The deceased's capital gain deemed to arise at death on disposition of the shares and reported in the deceased's terminal tax return

The result of this stop-loss provision is the capital loss realized by the estate that is available to reduce or eliminate the capital gain on the deemed disposition of the shares reported on terminal tax return is reduced by up to 50 per cent of the capital dividend.

There are potentially three approaches to reducing the impact of stop-loss rules.

- The 50 percent solution
- The roll and redeem strategy
- Grandfathering

50 percent solution

With this solution the amount of the deemed dividend designated as a capital dividend is restricted to 50 per cent of the lesser of:

- Capital gain on the deemed disposition of the shares reported on the deceased's terminal return
- Capital loss realized in the estate[3]

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[2] From 2016, only the estate that qualifies as graduated rate estate is allowed to carry-back the losses.

[3] From 2016, the estate must qualify as graduated rate estate to use this solution.

The effects of using this capital dividend restriction are:

- Estate receives both taxable and non-taxable dividends
- Stop-loss rules do not restrict the capital loss carry back amount
- Deemed capital gains on the deceased's terminal tax return can be offset by the estate's full capital loss which is carried back

From an income tax perspective, the 50 per cent solution may result in:

- The estate/beneficiary paying some tax on a taxable dividend
- The deceased having no net capital gain on the terminal tax return due to the deemed disposition of shares, and consequently recovery of tax paid from the loss carry back
- A balance in the capital dividend account available for paying tax-free dividends

From a cost-benefit perspective, the corporation and executor may want to compare the following to determine if the 50 per cent solution is suitable in their circumstances.

- Additional tax liability in the estate (due to a portion of the dividend being treated as a taxable dividend) and at a higher rate (because the tax rate on dividends is greater than the tax rate on the capital gains) than reporting the equivalent amount as a capital gain (due to stop-loss rules) in the deceased's terminal return
- Potential future tax savings on dividends to continuing shareholders resulting from the remaining balance in the private corporation's capital dividend account

Roll and redeem strategy

If the deceased shareholder has a spouse or common-law partner, the shares may be left to the spouse or common-law partner at the adjusted cost base of the deceased shareholder. Since this is a tax-deferred rollover, no tax is triggered to the deceased shareholder on death.

After the rollover, the corporation redeems the shares from the surviving spouse or common-law partner. The share redemption will result in deemed dividend income and a capital loss (to the extent that the adjusted cost base in the shares exceeds its paid-up capital). This capital loss will equal to the adjusted cost base in the shares less its paid-up capital.

The deemed dividend upon the redemption may be designated as a capital dividend. Assuming that the spouse or common-law partner is a resident of Canada no tax is payable on the capital dividend.

The stop-loss rules apply to the capital loss realized by the spouse/common-law partner. This stop-loss rule means the surviving spouse/common-law partner's capital loss is restricted based on the amount of the capital dividend and taxable dividend received by the spouse or common-law partner on the shares. Generally, the deceased's adjusted cost base in the shares of a private corporation is often nominal, so the capital loss realized by the surviving spouse/common-law partner upon the redemption may be a negligible amount. Accordingly, the tax impact of this stop-loss rule applying is much less.

The results of the roll and redeem strategy are as follows:

- The tax on the deemed capital gains on the death of the shareholder is deferred at death and no capital gains are realized by the surviving spouse/common-law partner when the shares are later redeemed.
- The surviving spouse or common-law partner may have little or no income tax to pay on the redemption of the shares when a capital dividend is used.

- The denial of a capital loss to the surviving spouse/common-law partner when his or her shares are redeemed, which may be a nominal amount in many cases.

Grandfathering rules

The stop-loss rules do not apply to a disposition of shares if there is either a pre-existing agreement or a pre-existing insurance. This means the full amount of the capital loss otherwise realized in the first year by an estate from share redemption can be carried back and fully applied against the capital gains in a deceased's terminal return.

a) Pre-existing agreement rule

Grandfathering is available if the share disposition (redemption) occurs pursuant to an agreement in writing made before April 27, 1995. Additional points to be noted in respect of this rule are:

- Changes to the agreement after April 26, 1995 may result in loss of grandfathered status of the shares, and consequently, the stop-loss rules could apply.
  - According to the Canada Revenue Agency (CRA) if the existing agreement is altered to such an extent that it would constitute a new agreement, the grandfathered status of the shares is lost. It is a question of fact whether changes result in a new agreement.
- According to the CRA, when shareholders execute a separate agreement revising the terms of their relationship, but leaving the original agreement unchanged, the grandfathering relief may be lost if the separate agreement can be considered to cancel, nullify or replace the original agreement.
- Buying new or additional life insurance, or the replacement or conversion of an existing policy, which funds a buy/sell agreement will not impact the grandfathered status of the shares under the pre-existing agreement.

b) Pre-existing insurance rule

Grandfathering is available under this rule if a corporation was the beneficiary of a life insurance policy on April 26, 1995; and it is reasonable to conclude that a main purpose of the policy was to fund the redemption of shares owned by shareholders on April 26, 1995. Additional points to be noted in respect of this rule are:

- This grandfathering rule also applies to shares owned by a trust on April 26, 1995 that are later distributed to an individual (who was the beneficiary of the trust on April 26, 1995), and then redeemed by the corporation from the individual, his or her spouse or common-law partner or a spousal trust
  - In this case the insurance policy must be on the life of the individual or his or her spouse or common-law partner, as the case may be.
- Shares being disposed of do not have to be the shares of the corporation that is the beneficiary of the life insurance policy. This is helpful in the case of a holding company/operating company situation, where the holding company's shares are disposed of and the operating company is the beneficiary of the life insurance policy.
- The shares need not be acquired with the proceeds of a life insurance policy that was in place on April 26, 1995. This means that the policy may be renewed or converted, and the purchase of additional life insurance coverage or policy replacement is permitted, without losing grandfathering.
- Grandfathering is also available for newer shares acquired in exchange (under other rollovers in the *Income tax Act* including sections 85, 86, 87 and 51) for grandfathered shares

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Advantages of funding share redemption using life insurance

- It is simple and easy to implement, especially when there are multiple shareholders.
- It provides the corporation with the funds needed to fulfill obligation under a buy/sell agreement.
- It provides comfort to the shareholders that their estate will receive the agreed value for their shares.
- Having the premiums paid by the corporation is a reasonable cost-sharing method since cost is effectively shared by the shareholders based on their proportionate interest in the company.
- Since the corporation is the beneficiary, there is generally no shareholder benefit from payment of premiums by the corporation.
- If the corporation is eligible for small-business deduction, the before-tax income required to pay the premium may be less than if the shareholders were to obtain the insurance personally and pay the premiums.
- For grandfathered shares, this method may provide an opportunity for the deceased shareholder to pay no tax on death and have the estate receive the entire redemption proceeds tax-free (if the entire dividend is treated as a capital dividend)

Disadvantages of the share redemption method

- Since the redemption of shares results in a deemed dividend, there is no possibility to claim the capital gains exemption.
- Since the shares are redeemed by the corporation, and not purchased buy the remaining shareholders, the remaining shareholders do not get a step-up in their shares' cost base, even though their proportionate ownership in the corporation increases after the share redemption. This may result in higher capital gains when the surviving shareholders dispose of their shares in the future, and a greater amount of income tax.
- The life insurance death benefit received by the corporation may be exposed to the claims of its creditors.
- The stop-loss rules may restrict the estate's ability to carry back the capital loss to the terminal tax return.

Tax-consequences—an example

This example will help us show the tax consequences of using the share redemption method. We will assume the following:

- John and Jim are residents of Canada and equal shareholders of J & J Inc., a private corporation.
- The adjusted cost base and paid-up capital of the shares owned by both John and Jim are $100 each.
- The fair market value of J & J Inc. is $4,000,200.
- The shareholder's agreement provides for the buy-out of the shares owned by a deceased shareholder using the share redemption method. The valuation formula provides for valuing the shares without considering the death benefit of the life insurance policy that the corporation as beneficiary will receive.
- J & J Inc. has purchased life insurance policies on each of John and Jim with a death benefit of $2,000,000 for each policy. The adjusted cost basis of the policy at the time of death is nil.
- John and Jim's marginal tax rate (MTR) is 50 per cent (25 per cent for capital gains). Their estate will have a 44 per cent marginal tax rate on non-eligible dividends.
- John and Jim have each used their enhanced lifetime capital gains exemption deduction.

If John were to die, the redemption will work like the following:

Terminal tax return for John

FMV of J & J Inc. shares deemed disposed of on death		$2,000,100
Adjusted cost base of shares		$ 100

Capital gain		$2,000,000

Taxable capital gain	(1/2 of capital gain)	$1,000,000
MTR		50%

Tax payable		**$ 500,000**
		========

On John's death, J & J Inc. will collect the death benefit of $2,000,000. As the adjusted cost basis of the policy is nil, the entire death benefit is credited to the capital dividend account of J & J Inc.

Pursuant to the terms of the shareholders agreement, J & J Inc. will then redeem the shares now held by John's estate.

The cost base of the shares to the estate will now be the fair market value of the shares or $2,000,100.

John's estate tax return

<u>Dividend income</u>	
Proceeds of redemption	$2,000,100
Paid-up capital of shares	$ 100

Deemed dividend	$2,000,000
Tax rate	44%

Tax	**$ 880,000**
	========
<u>Capital gain/loss</u>	
Proceeds of disposition	$2,000,100
Deemed dividend	$2,000,000

Revised proceeds of disposition	$ 100
Adjusted cost base of shares	$2,000,100

Capital loss	$2,000,000
	========
Allowable capital loss (1/2 of capital loss)	$1,000,000
	========

Generally, a capital loss realized by the estate can be used against the estate's capital gains. In this case, the capital loss is in the estate's tax return while the capital gain is in John's terminal tax return. The Income Tax Act allows carrying back a loss realized in the first year of the estate to the terminal tax return of John.

In John's case, if the allowable capital loss of the estate ($1,000,000) is carried back to his terminal tax return, it will fully offset the taxable capital gain of $1,000,000 reported on John's terminal tax return. This will allow for a refund of $500,000 of tax paid on the capital gain previously reported in John's terminal tax return.

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The net tax liability between the terminal tax return and estate's tax return will be $880,000 (i.e., $500,000 initial tax in John's terminal tax return plus $880,000 tax on deemed dividend income in estate minus $500,000 refund in John's terminal tax return from the capital loss carry back). This means that tax has been paid in the estate and at dividend tax rates.

If the deemed dividend in the estate is declared as a tax-free capital dividend, the stop-loss rules could apply.

If the stop-loss rules do not apply (i.e., grandfathering rules apply), the estate will not have to pay tax on deemed dividend income (because it is a tax-free capital dividend), and the loss carry back from the estate will result in recovery of tax paid in John's terminal tax return.

The result is no tax.

If the stop-loss rules apply:

- John's estate will not pay any tax on the deemed dividend if it is declared as a capital dividend.
- The amount of loss that can be carried back to John's terminal tax return will be reduced by the stop-loss rules.
- The result will be that only some of the tax paid in John's terminal tax return on the deemed capital gain can be recovered.

The calculation below shows the reduction in the loss carry back:

The reduction to the loss carry back is calculated as the lesser of:

- The capital dividend received on the estate's shares (i.e., $2,000,000)
- The amount of the estate's capital loss otherwise determined, less the taxable dividends received by the estate on the shares (i.e., $2,000,000 capital loss less $nil, as no taxable dividends were received by estate equals $2,000,000)

That exceeds 50 per cent of the lesser of:

- The amount of loss otherwise determined, (i.e., $2,000,000 as above)
- John's capital gain from the deemed disposition of shares on John's terminal tax return (i.e., $2,000,000).

The reduction will be $2,000,000 less 50 per cent of $2,000,000 equals $1,000,000. Therefore, the revised capital loss of the estate will be:

Actual capital loss	$2,000,000
Less: Loss reduction as above	$1,000,000

Capital loss after stop-loss rules applied	$1,000,000
	=========
Allowable capital loss	$ 500,000
	=========

Since only $500,000 allowable capital loss can be carried back to John’s terminal return, the tax recovery on John’s terminal tax return will be $250,000; instead of the entire $500,000.

As a result of the stop-loss rule, the net tax liability between John’s terminal tax return and the estate’s tax return is $250,000. In addition, J & J Inc. has used the entire credit of $2,000,000 to its capital dividend account (from receiving the insurance death benefit) to treat the estate’s dividend as a tax-free capital dividend.

The same example using the 50 percent solution

Using the 50 per cent solution, the portion of the deemed dividend declared as a tax-free capital dividend to the estate is restricted to 50 per cent of the total dividend. The estate would have the following tax consequences:

John’s estate tax return

Dividend income	
Proceeds of redemption	$2,000,100
Paid-up capital of shares	$ 100

Deemed dividend	$2,000,000
Less: Designated as capital dividend	$1,000,000

Taxable portion of deemed dividend	$1,000,000
Dividend tax rate	44%

Tax	$ 440,000
	========

Capital gain/loss	
Proceeds of disposition	$2,000,100
Deemed dividend	$2,000,000

Revised proceeds of disposition	$ 100
Adjusted cost base of shares	$2,000,100

Capital loss	$2,000,000
	========
Allowable capital loss	$1,000,000
	========

When calculating the impact of the stop-loss rules in this context, the reduction to the loss carry back is calculated as the lesser of:

- The estate’s capital dividend received on shares (i.e., $1,000,000)
- The amount of the estate’s loss otherwise determined less the taxable dividends received by the estate on the shares (i.e., $2,000,000 less $1,000,000 equals $1,000,000)

That exceeds 50 per cent of the lesser of:

- The amount of the loss otherwise determined (i.e., $2,000,000 as above)
- John’s capital gain from the deemed disposition of shares on John’s terminal tax return (i.e., $2,000,000).

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The reduction to the loss carry back will be $1,000,000 less 50 per cent of $2,000,000 equals $nil. As a result, the revised capital loss of the estate will be:

Actual capital loss	$2,000,000
Less: Loss reduction as above	$ Nil

Capital loss after stop-loss rules applied	$2,000,000
	=========
Allowable capital loss	$1,000,000
	=========

This would mean 100 per cent of the estate's capital loss can be carried back to John's terminal tax return, and offset the capital gain in John's terminal tax return. Consequently, all tax paid in John's terminal tax return (i.e., $500,000) due to the deemed capital gain can be recovered.

The end result is a net tax liability of $440,000 between John's terminal tax return and estate's tax return. This is $190,000 more than the tax payable if the stop-loss rule is applied in the first scenario (used all $2,000,000 of the capital dividend account to have the redemption deemed dividends tax-free to the estate).

By using the 50 per cent solution, $1,000,000 credit remains in the capital dividend account of J & J Inc. and can be used to pay future tax-free dividends to the shareholders.

Assuming a 44 per cent tax rate on a taxable dividend, the value of this $1,000,000 credit in the capital dividend account is $440,000.

Considerations for using the 50 percent solution

If John and Jim are dealing at arm's-length, John would prefer paying less total tax (between his terminal return and his estate), and therefore the 50 percent solution may not be attractive to him.

If John and Jim are related (e.g., father and son), John may find the 50 per cent solution desirable. In this case, John may not object to paying $190,000 more in taxes between his terminal tax return death and the estate from the redemption of its shares, because his son, Jim, can potentially save $440,000 in future taxes.

The above example is for illustrative purposes only. Situations will vary according to specific circumstances.

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When the life insurance policy is purchased

When one of the shareholders dies