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Wills, Taxes and  
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# Law

Issues in Law You Need To Know

## Shareholders' Agreement & Tax Implications: Are You Informed?

*When two people decide to begin a business venture, the implementation of a shareholders' agreement is a key to preventing unfortunate consequences at a later time. The primary purpose of a shareholders' agreement is to define the relationship amongst the parties and should include the procedure and actions to be taken in the event the relationship sours over time or in the event that the parties change due to disability or death. Ultimately, a shareholders' agreement aims at establishing provisions for future key decisions to deal effectively with any possible event and circumstance that may arise.*

However, as each situation is unique and requires an agreement that meets the intention of the parties it is preferable to avoid a "boilerplate agreement", which are often ill-suited to the specifics of the shareholders' goals and may fail to result in the most tax efficient outcome.

The following sets out a few provisions that should always be care-

fully considered and fully understood.

### Survivorship Arrangements

One of the primary functions of a shareholders' agreement is to provide for a buy-sell arrangement upon the death of a shareholder. Provisions are made for how a deceased shareholder's shares will be dealt with and how the obligations of the surviving shareholders will be funded. These provisions should be structured so as to provide the most tax efficient result for all parties involved.

Certainly, one of the most tax effective strategies to fund such a buy-sell arrangement is to purchase life insurance on the lives of each shareholder and designate the corporation as the beneficiary. The life insurance proceeds are received on a tax-free basis by the corporation and will thereby increase the capital dividend account. Depending on the shareholders' agreement, the corporation may then issue



a tax-free capital dividend to the surviving shareholders in order for them to purchase the shares from the estate. Such a clause is best implemented when the deceased shareholder has not claimed his or her capital gain exemption prior to death.

If the deceased shareholder has already claimed his or her capital gain exemption, then it may be

preferable to include a clause in the shareholders' agreement that the corporation will redeem the deceased shareholders' shares. Again, the goal is to have the corporation receive the life insurance proceeds in order to increase the capital dividend account. The corporation would then repurchase the deceased's shares by issuing a tax-free capital dividend to the estate.

All survivorship arrangements in a shareholders' agreement have tax implications that must be considered. There is no "magical template" as all shareholders' agreements should be tailored specifically to the shareholders' goal and intentions.

### Control and the Association Rules

Another provision that requires careful consideration in a shareholders' agreement is the avoidance of the association rules. Where a shareholder, or a related group of shareholders, owns or controls more than 50% of the voting shares of a corporation, that shareholder or group will control the corporation. Consequently, any other corporation controlled by the controlling shareholder or group may be found to be associated with the first corporation. If two or more corporations are

found to be associated, it will trigger a number of income tax consequences including, inter alia, a requirement to share the small business deduction as well as other deductions in computing income.

Sections 256 of the Income Tax Act defines the association rules and these rules should be fully understood by the drafter of the shareholder's agreement as well as all parties involved in order to avoid regrettable tax consequences.

### Other Provisions to Consider

There are several other provisions commonly included in a shareholders' agreement that, unless carefully considered, may have adverse income tax consequences.

One example is where a shareholders' agreement provides for a "call option" allowing the majority shareholder to require that a minority shareholder sell his or her shares at a fixed price or at a price determined by a formula which could potentially exceed the fair market value of the shares at the time the call option is exercised. In that case, the shares held by the minority shareholder will be considered to be short term preferred shares from the moment of their issuance. This may result in the acquisition price being based on

the fair market value of the shares at the time the agreement was entered into rather than at the time of acquisition.

Another example of a potential planning pitfall is in the drafting of provisions for arrangements to be made in the event a shareholder becomes disabled who can no longer return to full-time activity. Another buy-sell provision may be considered as it would avoid such a situation becoming a burden for the other shareholders who would otherwise have to provide continuing support for the disabled shareholder for a lengthy period of time. How can one fund such a buy-sell arrangement? Although income replacement insurance may be an option, it is important to note that proceeds of income replacement insurance do not increase the capital dividend account of the corporation and, therefore, cannot be transferred to the shareholder on a tax-free basis. If the shareholders opt for a corporate repurchase of the shares, consideration should be given to reorganizing the share capital of the corporation allowing for the creation of frozen, redeemable preferred shares which can be redeemed or purchased over time; for the disabled shareholder this would only trigger a tax liability as the proceeds are received and it also completely avoids depletion of the reserves of the corporations.

In the not-so-uncommon situation where a shareholder of a corporation is another corporation and the holding corporation is used to hold the shares of the operating corporation, the buy-sell arrangements may be amended to provide for the most tax efficient result possible. In such a case who shall hold the life insurance policy? Who shall pay the premiums? Can we avoid a shareholder benefit? Should we consider use inter-corporate tax-free dividends to repay the payment of premiums thus avoiding a shareholder benefit? These are all questions that should

be answered prior to the drafting of the shareholders' agreement.

### Conclusion

The foregoing are just a few examples of issues that should be discussed prior to the drafting of the shareholders' agreement. As previously mentioned, using a "boilerplate agreement" may result in undesirable tax outcomes that could have been completely avoided had the drafter foreseen the potential pitfalls and fully understood the fiscal repercussions of the various provisions.

We always recommend shareholders implement a shareholders' agreement at the commencement of business while all the parties are on good terms. We also recommend shareholders seek professional advice from the outset as any attempts to resolve issues "after the fact" may turn out to be catastrophic for the shareholders and for the business and the costs will most surely exceed the initial expense of a well drafted shareholders' agreement prepared by a fully informed professional advisor.

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### CALL TO THE BAR

Law Society of Upper Canada, 2007

### EDUCATIONAL BACKGROUND

- University of Ottawa, LL.L., 2007
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### PRACTICE SUMMARY:

Sébastien joined Tierney Stauffer LLP as an Associate in the Wills, Estates & Trusts Planning & Administrative Practice Group in 2009. His practise focuses on estate planning, will drafting and personal and corporate taxation. Sébastien has experience in resolving disputes with the Canada Revenue Agency (CRA), filing voluntary disclosures, assisting individuals with their tax related issues and tax planning for families and businesses. Sébastien is bilingual and practices in both official languages.

He has spoken at various seminars on estate, trust and tax matters. Sébastien has also appeared on radio and television discussing legal issues. He is a tutor for the Law Society of Upper Canada for the Estate Practice section.

Prior to joining Tierney Stauffer LLP, Sébastien practiced with another Ottawa law firm where he gained experience in tax law, charity law, estate planning and will drafting.

