An Independent Member Firm of DFK Canada Inc. and DFK International

Newsletter

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Does your Corporation need a Shareholders' Agreement?

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The concept of a shareholders' agreement is similar to that of a marriage contract except it involves all the shareholders of a corporation and their relationship with the company and each other. If there is only one shareholder of the corporation, an agreement is not needed, however, if there is more than one, it is strongly recommended those shareholders develop an agreement to govern the corporation's management and administration. Having an agreement in place can help minimize disputes between shareholders and ensure all shareholders are treated in a fair and equitable manner. A shareholders' agreement is also commonly referred to as a buy-sell agreement as it usually sets out how to deal with shareholders' interests when it is time to divest of their shareholdings.

Here are some questions you may want to ask yourself:

- If you are one of two shareholders that each own 50 per cent of a corporation, would you want to be in business with the surviving spouse after the other shareholder dies?
- When you die, how are your loved ones going to receive the benefit of what you have worked for?
- What is to happen if one of the shareholders becomes disabled and is no longer able to be an active part of the corporation's management?
- When the time comes that you want to retire and liquidate your shareholdings, how is this going to be facilitated? Who is going to buy your shares? The other shareholder? The company? A third party?

Therefore, the following are some of the main elements commonly addressed in a shareholders' agreement:

- Management and administration of the corporation;
- Triggering events (such as death, disability, retirement, divorce or bankruptcy) that may either permit or require the sale of shareholdings;
- For each triggering event, the process that will be followed to effect the withdrawal of the shareholder (i.e. share purchase by other shareholders or by the company itself), the method of determining the sale price and terms of payment.
- Corporate-owned life insurance is commonly used to help fund the purchase of a deceased shareholder's interest. When applicable, the agreement will provide detail as to the method by which the shares will be bought-out.

Drafting a shareholders' agreement is a dynamic process that includes honest and open discussions between all parties. The corporation's accountant can help facilitate this process and may also recommend a lawyer be included during the discussions. This will not only guide the drafting of the agreement but will ensure it properly addresses the concerns of the shareholders.

If you would like more information about developing a shareholders' agreement, please contact your local DFK advisor.

Inside this issue:

"Success is simple. Do what's right, the right way, at the right time."
- Arnold H. Glasow

Special points of interest:

- *Personal tax return deadline is April 30th.*
- *Deadline to purchase RRSPs is March 1st.*
- *Are you paying your corporate instalments—tax & HST?*
- *Personal tax instalments:*
  - *March 15, 2011*
  - *June 15, 2011*
  - *September 15, 2011*
  - *December 15, 2011*

Capital Dividend Account (CDA) – Life Insurance Proceeds

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A private corporation can pay tax-free dividends to shareholders residing in Canada (foreign shareholders being subject to a non-resident withholding tax) from its Capital Dividend Account (CDA), provided the proper documents and procedures are followed. In general terms, a CDA is the sum of four amounts, being a) the non-taxed portion of net taxable capital gains, b) capital dividends received from other corporations, c) the non-taxed portion of eligible capital property (the sale of goodwill or government quotas, for example), and d) the proceeds of a life insurance policy. It is then reduced by prior capital dividends paid.

A recent Tax Court of Canada case dealt with the addition to the CDA in a situation where a company put key man insurance in place as security for a bank loan. When the shareholder died, the insurance proceeds of $196,000 were paid directly to the bank, since it was the beneficiary of the policy. The bank used about $175,000 to repay the company's bank loan at the time and put the $21,000 balance on deposit for the company.

The company added the $196,000 to its CDA and then paid capital dividends of $160,000. The Canada Revenue Agency (CRA) excluded the insurance proceeds from its calculation of the company's CDA, thereby resulting in an "over-election," causing an assessment of penalty tax.

The CRA's position was there was no inclusion to the CDA, since the bank, not the company, was the beneficiary, and the bank received the net proceeds of the policy. Apparently, the Minister made the submission to the Court that the meaning of "capital dividend account" can be determined with reference to its Interpretation Bulletin IT-66R6, which states the CRA view that the CDA is to include "the net proceeds of a life insurance policy received after May 23, 1985, by the corporation as beneficiary under the policy."

The judge then reviewed the Income Tax Act and found no requirement that the corporation be a beneficiary under the policy. The Act was clear in that it required the company to not be a "beneficiary on or before June 28, 1982" (which it was not; the policy coming into existence in 1999), and the proceeds must be "received by the corporation . . . in consequence of the death of any person . . ."

After a careful review of the facts, as well as several prior cases, the judge concluded the insurance proceeds were "received" by the company despite never passing directly into the company's hands. He found "the case law to be clear that an amount may be included . . . even where it is only notionally or constructively received." Therefore, the full $196,000 was properly included in the company's CDA. Upon appeal, the ruling was upheld by the Federal Court of Appeal.

While it is always preferable to structure one's affairs to meet the views of the CRA in order to reduce the risk of conflict, this case clearly demonstrates the potential advantages that can be gained from a careful and thoughtful analysis of the Income Tax Act and the CRA's stated views. Taxpayers should never merely accept the CRA's views as being correct.

Key Employee Share Ownership Participation in Private Corporations

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The high level of performance of key employees is one factor that contributes to the success of a business.

The topic of share ownership participation by key employees is addressed in some situations either at the employees' request, or at the business owner's initiative.

A business owner may want to offer share ownership as an employee retention tool, or to create a group of minority shareholders who would buy the shares when the owner is ready to move on or retire.

An employee would be interested in share ownership for the same reasons an owner is interested in being an owner. Some of these reasons are participation in management at a higher level, financial rewards from dividends and capital gains on the sale of their shares, etc.

Four common methods of developing an effective private corporation employee share ownership program in an income tax efficient and practical manner are:

1. **Sale of shares from the current owner for fair market value (FMV).**

   This is the simplest method and is appropriate when the share value is low or moderate, the number of employees purchasing shares is small, the price is affordable to them, or the current business owner is willing to get paid over a period of time. It is generally advisable for all methods of sale that the key employees pay some portion of the consideration at the transaction date to have a vested interest and commitment to the share ownership process.

Business owners and employees share the same motivations for wanting share ownership.

2. **Sale of shares from the company's treasury pursuant to an Employee Stock Option Plan ("ESOP") for FMV, or below FMV.**

   This method is appropriate when the corporate value is substantial and the share issuance is to be made to a large group of employees with the main purpose being long-term employee retention.

3. **"Partial Freeze" of the currently issued shares followed by the sale of shares from the current owner to the key employees.**

   This method is appropriate when the share value is substantial and the number of key employees purchasing is small. The "Partial Freeze" technique involves converting a portion of the current owner's common shares into fixed value preferred shares. That, in effect, reduces the number of the common shares to a value that results in a manageable share purchase price for the key employees. The purchasers can pay for the shares from either personal funds or from future dividends received from the corporation.

4. **"Full Freeze" of the currently issued shares followed by the issuance of new common shares to the key employees and the current owner from the corporation's treasury, for nominal consideration.**

   This method is similar to the "Partial Freeze" and is appropriate when the key employees have limited financial resources to devote to the share purchase.

While key employee share ownership changes the way that the current business owner operates and manages the business, the results could be rewarding to all parties concerned and could enhance the long-term success of the business.

Family Trusts at Risk to Matrimonial Law?

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The recent Alberta court decision, *Horne v. Horne*, addressed the issue of whether the definition of "property" in the Matrimonial Property Act of Alberta (MPA) included a contingent interest in a testamentary trust. The court had to consider an interest in a testamentary trust that would only be allocated to the beneficiaries upon a future event, in this case the death of Ms. Horne's mother. Ms. Horne, separated from Mr. Horne in 2006, was one of the named beneficiaries. The court had to decide whether Mr. Horne had any claim over Ms. Horne's future interest in the trust, and whether he was entitled to share in the increase in value from the beginning of the marriage. Ms. Horne's potential interest in the trust exceeded $600,000 in growth over the course of the marriage.

The court decided the contingent interest was matrimonial property, but Ms. Horne was to retain her contingent interest in the testamentary trust on the basis that this was a just and equitable result. The testamentary trust had no link to the marriage partnership, and did not affect their financial lives or their retirement plans. This decision is under appeal.

Please note this decision was in Alberta, and could vary across Canada as different matrimonial laws apply to each province. A contingent interest in a testamentary trust is similar to a discretionary interest in a family trust. In Ontario, court cases such as *Sagl v. Sagl* have decided a discretionary interest in a family trust is matrimonial property. For Alberta, one thing is clear; it is an increasing reality that a discretionary interest in a family trust is within the realm of matrimonial property.