Holdco a party to the shareholders' agreement and to procure appropriate covenants from such party with respect to the disposition of shares of Holdco in order to ensure that an indirect transfer of the interest held by Holdco does not take place through a sale of the shares of Holdco by its shareholder(s). Thus, shareholders' agreements frequently include as parties persons who are not shareholders.

Parties to a shareholders' agreement might include all (if the agreement is to be a unanimous shareholders' agreement) or some of the shareholders of the corporation, as well as the individual or controlling shareholders of corporate shareholders. If there is a possibility that spouses of individual shareholders may come to have an entitlement to own shares of the corporation as a result of divorce proceedings or death and the shareholders' agreement provides a contractual arrangement which contemplates a waiver of such rights, then it may be advisable to add the spouses as parties to the agreement and ensure that they receive independent legal advice in connection therewith. In this regard, please refer to the discussion below regarding matrimonial property concerns. The corporation itself should be added as a party to all unanimous shareholders' agreements if the provisions of any shareholders' agreement are intended to be enforceable against it. If the shareholders' agreement contains buy-out provisions that contemplate payment for the purchased shares over a period of time pursuant to a promissory note and there is security granted for such payment obligations by way of a share pledge, the parties might consider adding as a party the trustee (escrow agent) holding such pledged shares pending full payment of the promissory note. As the examples discussed above illustrate, it is important for shareholders to ensure that they have achieved privity of contract with the appropriate parties in the event that they need to enforce their rights under the agreement.

¶130 Recitals

Recitals to an agreement do not have any legal effect, but they set an interpretive context for the binding provisions of the agreement which follows. Recitals may thus become decisive if a dispute arises under the agreement and an adjudicator, such as a judge or arbitrator, is called upon by the parties to interpret seemingly ambiguous provisions in the agreement. The main body of a shareholders' agreement will sometimes contain an acknowledgment by the parties with respect to the facts set out in the recitals in order to preclude any future debate as to their truth or accuracy.

¶135 Consideration Clause

One of the elements to the formation of a binding and enforceable contract is consideration (i.e., often thought of as "value"). Therefore, a shareholders' agreement that contains a clause that makes it clear that there was consideration is less likely to be challenged on the basis that it is not enforceable for lack of consideration.

¶140 Business of the Corporation

The business or undertaking of the corporation may be briefly described, especially if the shareholders wish to mandate the continuation of the same business activity of the corporation without material change.

¶145 Interpretive Provisions

It is common to find basic interpretive provisions in most contracts. Though often regarded as mere "boilerplate", these provisions can become very important and should not be underestimated. For example, shareholders' agreements sometimes contain provisions which are inconsistent with the contents of corporate by-laws. In the absence of an interpretive clause which identifies the paramountcy of one document over the other, shareholders may find themselves in a quandary.

¶150 Organization and Management of the Company

Most corporate legislation in Canada, including the OBCA[2] and the CBCA[3], provides that the directors of a corporation determine the manner in which the affairs of the corporation will be conducted. As stewards of corporations, directors owe fiduciary duties and certain statutory liabilities are imposed upon them. This statutory framework may be altered by an agreement among all of the shareholders of a corporation, referred to as a unanimous shareholders' agreement under the OBCA and the CBCA. Such legislation contemplates that a unanimous shareholders' agreement may, in whole or in part, restrict the powers of the directors of a corporation to manage its business and affairs. It is important to note that both the OBCA (subsection 108(5)) and the CBCA (subsection 146(5)) stipulate that shareholders who restrict the powers of the directors of a corporation to manage the business and affairs of the corporation assume all of the rights, powers, duties and liabilities of such directors and the directors are relieved of such rights, powers, duties and liabilities to the same extent. By contrast, an "ordinary" shareholders' agreement is merely an agreement among shareholders as to how, among other things, each of them will exercise their voting rights and cannot circumscribe the discretion of the directors to manage the affairs of a corporation. Accordingly, shareholders who intend to enter into a unanimous shareholders agreement should be aware of the risk of potential liability which goes hand in hand with the performance of the functions which are normally reserved for directors.

The array of potential organizational and management matters that may be dealt with in a unanimous shareholders' agreement is extremely broad and the precise contents of a particular unanimous shareholders' agreement will ultimately be determined by the business deal of the constituent shareholders. The OBCA and the CBCA specifically contemplate that unanimous shareholders' agreements may:

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[2] R.S.O. 1990, c. B.16.

[3] R.S.C. 1985, c-44.

shares, all without triggering the right of first refusal contained in the shareholders' agreement.

Accordingly, if it is the intention of the parties to a shareholders agreement to preclude testamentary transfers and avoid the effective result of the above-referenced case, a shareholders' agreement might include specific provisions with respect to how each shareholder's last Will and Testament (and any codicil thereto) will treat the shares on death. Moreover, consideration ought to be given to the merits of including an appropriate call option in relation to a deceased shareholder's shares that may be triggered by any one or more of the surviving shareholders. Note that the precedent agreement contained in Appendix I contains provisions which stipulate a mandatory transaction of purchase and sale in the event of death, which may serve to obviate some of the uncertainty that flows from the above-referenced Court of Appeal decision.

Permitted Transferees

Shareholders' agreements frequently contain special provisions to facilitate tax planning which permit share transfers to "permitted transferees," such as family holding companies, trusts or family members, provided that the new shareholder agrees to be bound by the agreement and provided that the existing shareholder continues to be principally liable for all obligations under the agreement. A transfer of shares to a holding company may be completed in a manner which does not trigger a taxable event, assuming that required tax elections are made under section 85 of the *Income Tax Act* (Canada) (the "Act")[6] and, where applicable, the equivalent provision in the *Taxation Act* (Quebec),[7] and the shares issued by the holding company are structured so as not to confer a benefit on related shareholders.[8]

Applicable Matrimonial Property Laws

Shareholders' agreements may attempt to anticipate the potential effects of applicable matrimonial property laws[9] in order to ensure that spouses of shareholders do not become unintended shareholders of the corporation or parties to the agreement.

[6] R.S.C. 1985 c. 1 (5th Supp.) as amended. Unless otherwise indicated, all statutory references are to the *Income Tax Act* (Canada). See "How to Use This Book" on page iv for abbreviations and acronyms used herein.

[7] R.S.Q. I-3 as amended.

[8] Interpretation Bulletin IT-291R3, "Transfer of Property to a Corporation Under Subsection 85(1)", dated January 12, 2004.

[9] The authors of this text practice law in Ontario. Thus, any comments about specific matrimonial property legislation in this Chapter and others will refer to the *Family Law Act*, R.S.O. 1990, c. F.3, as amended (the "FLA"). Readers in other jurisdictions should review the provisions of the relevant matrimonial property regime when drafting, reviewing, revising, or commenting upon, a shareholders' agreement. In addition, consideration may have to be given to any orders issued under the *Divorce Act*, R.S.C., 1985, c. 3 (2nd Supp.).

For convenience, we are using the terms "spouse", "spouses", and "spousal" to refer to all marital or cohabiting relationships of some permanence, whether the relationship is between members of the same or the opposite sex. This terminology does not necessarily accord with that used in matrimonial property legislation across Canada, so readers should be aware of this discrepancy.

The definition of "spouse" and who may be entitled to a division of assets or income support on the breakdown of a marital or cohabiting relationship of some permanence has changed significantly since the mid-1990s and continues to do so. It is essential, therefore, that the drafter of a shareholders' agreement be aware of the ongoing evolution in this area of law and be prepared to adapt the provisions of any precedents on a periodic basis. In addition, the entitlement to a division of assets on breakdown of a spousal relationship may be addressed in a domestic contract such as a marriage contract, cohabitation agreement or other similar arrangement that is binding on both parties. Therefore, the drafter of the shareholders' agreement should be aware of the provisions of any such agreement or arrangements that may affect the rights of a spouse.

For example, if executives of the corporation own shares, then their spouses could agree in writing that such shares are not to be included in any calculation of the division of assets between spouses under the relevant provincial/territorial legislation. Alternatively, the non-shareholder spouse may be asked to agree in writing that any order obtained under the governing matrimonial property legislation or the federal *Divorce Act* will not be satisfied with the shares of the corporation. If the subject spouses are to be parties to the shareholders' agreement with provisions which limit their rights as spouses, each must obtain independent legal advice, and care should be taken to ensure that there is compliance with the formal requirements of the governing matrimonial property legislation. In Ontario, such provisions would be considered a domestic contract and may be unenforceable if the requirements for a valid and enforceable domestic contract, such as full asset disclosure and independent advice, are not met. Another option available to shareholders is to provide a call right (discussed below) to either or both of the corporation and the other shareholders in respect of any shares which become the subject of matrimonial property proceedings.

If, on the other hand, both spouses are shareholders, then: (a) the other spouse may wish to have the first right and option to purchase the shares on death or on breakdown of the relationship, in which case the shareholders' agreement should provide a formula for determining the purchase price for the settlement of outstanding loans to and from the spouse, for resignation of the spouse as an officer and director of the corporation, for the release of the spouse from any guarantees in favour of the corporation; and (b) if a spouse who is active in the business dies, withdraws, or retires, then the shareholders' agreement could provide that the other spouse is required to sell the shares to the other shareholders. In either case, depending on the applicable jurisdiction, an agreement with such provisions may be deemed to be a domestic contract, in which case care must be taken to ensure enforceability.

Changes in Issued Capital

Shareholders' agreements should attempt to address the effects of changes in the ownership structure of a corporation which may result from the issuance of additional shares or other securities in the future. A new or amended shareholders' agreement may become necessary or appropriate to address such of the corporation by the CRA or any other tax authority for a fiscal period during which the vendor was a shareholder;

(2) resignations of officers, employees and/or directors of the corporation;

(3) the vendor and the purchaser(s) may release each other from any liability for past actions excluding obligations arising from the transaction of purchase and sale;

(4) if appropriate restrictive covenants are not already contained in the shareholders' agreement, it may be prudent to have the withdrawing shareholder enter into reasonable restrictive covenants with respect to confidentiality, non-competition and non-solicitation to protect the goodwill of the business as a condition to the completion of the transaction of purchase and sale; and

(5) certificates issued pursuant to section 116[12] to deal with the purchaser's statutory withholding tax obligations in the event that the selling shareholder is a non-resident of Canada.

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Income Tax Implications of Buy-Sell Provisions

The buy-sell provisions of shareholders' agreements can have varying income tax consequences for the selling and purchasing shareholders. Key considerations are the relationship of the parties with one another, the buy-sell structure that is used, the timing of the purchase or sale of shares, and the chosen funding vehicle that is to be used. (The tax implications of the most common buy-sell structures will be addressed in full in Chapter 2 — Tax Considerations — *Inter Vivos* Buy-Outs).

Thus, it is essential that shareholders and their advisors appreciate various "relationship" provisions contained in the Act, as they affect the tax consequences of buy-sell provisions in a shareholders' agreement. The three categories are related persons in section 251, affiliated persons in section 251.1, and associated corporations in section 256.[13] Each category determines differently the nature of the relationship for tax purposes between individuals and corporations. These categories apply to both *inter vivos* and *post-mortem* transfers of shares between shareholders or their estates. Appendix 2 deals with these concepts in greater detail. What follows is a brief summary.

As noted previously, many private corporations in Canada are owned by family members. In recognition of this, paragraph 251(2)(*a*) provides that individuals who are related to one another by blood, adoption, marriage or common-law partnership are related, and subsection 251(1) provides that

[12] Information Circular IC72-17R5, "Procedures concerning the disposition of taxable Canadian property by non-residents of Canada — Section 116", dated March 15, 2005.

[13] Interpretation Bulletin IT-64R4, "Corporations: Association and Control [Consolidated]", dated October 13, 2004.

related persons are automatically considered not to deal with one another at arm's length for income tax purposes.[14]

Paragraph 251(2)(*b*) provides that the term "related persons" also includes a corporation and the person who controls it, as well as corporations controlled by a common group of shareholders or persons related to such corporations.

The category of "affiliated persons" is delineated in section 251.1, which was added by the 1995–1997 technical bill as part of the so-called "pregnant stop-loss" anti-avoidance rules. The affiliated persons rules now also deal with affiliation in relation to partnerships and trusts. This section must be considered whenever a buy-sell arrangement utilizes the redemption of shares as a mechanism whereby ownership and control of the corporation are transferred between shareholders. In addition, planners and drafters should be aware of the effect that section 256, which contains the associated corporation rules, may have on proposed shareholders' agreements that contain buy-sell provisions.[15]

Under the related persons and associated corporation rules set out in sections 251 and 256, a person will be regarded as the owner of shares that he or she has a contractual right to acquire or to cause the corporation to redeem or cancel otherwise than on death, permanent disability or bankruptcy. In addition, where a person has the right to cause a corporation to redeem or cancel shares otherwise than on death, permanent disability or bankruptcy, those shares are deemed to have been acquired by the corporation, with the result that a relationship or association is established between the parties. Neither a right of first refusal nor a shotgun buy-sell arrangement appear to offend this rule, at least in the context of the association rules,[16] but the impact on any other companies owned by the shareholders should be considered where the shareholders' agreement provides for a mandatory sale otherwise

[14] Interpretation Bulletin IT-419R2, "Meaning of Arm's Length", dated June 8, 2004. It should be noted that the definition of related persons was amended in the wake of the June 10, 2003 decision of the Ontario Court of Appeal in *Halpern v. Canada (Attorney General)*, 65 O.R. (3d) 161, (2003) 225 D.L.R. (4th) 529, which found that the federal definition of "marriage" was unconstitutional. Subsection 252(3) provides an extended meaning of "spouse" and "former spouse" to include another individual who is a party to a void or voidable marriage with the particular individual.

[15] The association rule contained in section 256 is relevant for several purposes. The rules were primarily introduced to force Canadian controlled private corporations to share the pool of income subject to the low rate of business tax applicable to "active business" income available both at the federal and provincial level. In order to avoid the multiplication of several pools within family or commonly controlled groups, the association rules require a single pool to be shared among "associated" corporations. The association rules are also used for other purposes including requiring sharing the expenditure limit for investment tax credits: subsection 127(10.2) and (10.4), the refundable investment tax credit provisions in subsection 127.1(2), extended final tax payment deadlines where associated corporations' taxable income do not exceed $500,000: see definition of "balance due date" in subsection 248(1), and associated corporations which share dividend allowance for Part VI.1 tax in subsections 191.1(2) and (4).

[16] See Interpretation Bulletin IT-64R4, "Corporations: Association and Control [Consolidated]", dated October 3, 2004. See the CRA's view in document 9214367, in which the CRA confirmed that paragraph 251(5)(*b*) does not apply to a "right of first refusal" and does not usually apply to a shotgun arrangement. Note however that the parties must already be shareholders.

when partners carry on business in common with a view to profit in a non-arm's length relationship.

The purpose of subsection 18(13) is to prevent a taxpayer from claiming a loss on the "superficial" disposition of a business property. The loss is preserved in the hands of the transferee because of its "special relationship" with the transferor; the loss remains under the control of the transferor. To allow the loss to be preserved absent a non-arm's length relationship would violate the "fundamental premise" underlying subsection 18(13).

The Court concluded that the use of the combined effect of section 96 and subsection 18(13) to preserve and transfer a loss to a taxpayer who deals at arm's length with the transferor is "abusive tax avoidance" under subsection 245(4) of the Act. The abusive nature of the transaction is "confirmed by the vacuity and artificiality" of the non-arm's length relationship between the transferor and the transferee. The Court held that the series of transactions frustrated Parliament's purpose of confining the transfer of losses in a non-arm's length partnership. Accordingly, the Court ruled against the taxpayers.

Consequently, there are two main arguments against an application of GAAR to a particular transaction. The first is to establish that the transaction was undertaken primarily for *bona fide* purposes other than to obtain a tax benefit. If that argument fails, it can be argued that, although the transaction is an "avoidance transaction", it does not result in a misuse of a specific provision or an abuse of the Act when read as a whole; that is, the results flowing from the transaction are within the object and spirit of the Act, in the sense that the result obtained is appropriate and is contemplated by the Act and its specific provisions.

In determining whether a transaction or series of transactions has resulted in a tax benefit, it is not clear whether what was done should be compared to some normative transaction which would have given rise to more onerous tax consequences, or whether it is enough if the tax position of some taxpayer is better after the transaction or series of transactions than it was before. This second approach was accepted by the Tax Court in *Canada Trustco Mortgage Co. v. R.*[39] In *OSFC Holdings Ltd. v. R.*,[40] the Federal Court of Appeal followed the second approach as well, but without raising the issue. In *Canadian Pacific Ltd. v. R.*,[41] the Federal Court of Appeal appeared to follow the first approach, but again without raising the issue. Despite the statements made by the Tax Court in *Canada Trustco Mortgage Co. v. R.*, based on *Canadian Pacific*, we think it quite likely that a court might seek to apply the first approach or be willing to consider both approaches and conclude that a tax benefit results if a tax benefit would be found under either of the two approaches.

[39] 2003 DTC 587; 2003 T.C.C. 215.

[40] 2001 DTC 5471; 2001 F.C.A. 260.

[41] 2002 DTC 6742.

The Supreme Court of Canada released its third GAAR decision a little over three years later on January 8, 2009 in *Lipson v. The Queen*.[42] The Supreme Court held that GAAR applied in this case.

The facts of the case are as follows: On August 31, 1994, Jordanna Lipson, the Appellant's wife, borrowed $562,500 from a bank. Mrs. Lipson used the borrowed funds to purchase shares of a family-owned corporation from the Appellant at their fair market value. On September 1, 1994, Mrs. Lipson and the Appellant borrowed $562,500 from a bank on the security of a mortgage on a home they acquired on the same day. The mortgage proceeds were used to repay the first loan. No election was made by the Appellant to avoid the application of subsection 73(1).

Accordingly, notwithstanding that the shares were sold by the Appellant to Mrs. Lipson at fair market value, for the purposes of the Act, the sale was deemed to have taken place at the Appellant's adjusted cost base so that he realized no gain or loss. The interest deduction was justified on the basis of subsection 20(3), which provides that interest on money borrowed to repay money borrowed for the purposes contemplated by subparagraph 20(1)(*c*)(i) is deductible. Interest is deductible under subparagraph 20(1)(*c*)(i) if it is paid pursuant to a legal obligation to pay interest on borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt or to acquire a life insurance policy). Under subparagraph 20(1)(*c*)(i), interest on money borrowed to acquire dividend-paying shares is deductible, while interest on money borrowed to acquire a principal residence is not. Pursuant to the attribution rules in subsections 74.1(1) and 74.2(1), any income or loss from the shares and any gain or loss on the disposition of the shares realized by Mrs. Lipson would be deemed to be the Appellant's. As a result, the income from dividends on the shares and the interest expense under the mortgage were attributed to the Appellant for tax purposes. Therefore, it was the Appellant who, in computing his income, deducted the interest expense less the amount of the dividends from the shares.

The Minister reassessed the transaction to deny the interest deduction, relying on the decision of the Tax Court of Canada in *Singleton v. The Queen*,[43] on the basis that the "true economic purpose" for the borrowed money was used to purchase a home, rather than earn dividends on the shares.

The taxpayer appealed to the Tax Court of Canada and, at trial, the Minister relied on GAAR to support the reassessments. The Minister had to change its basis for assessment because by the time the *Lipson* case came before the Tax Court of Canada, the Tax Court decision in *Singleton*, which held that interest was not deductible where the true economic purpose of the borrowing was to acquire a principal residence, had been overruled by the Federal Court of Appeal[44] and by the Supreme Court of Canada.[45]

[42] 2009 SCC 1; 2009 DTC 5015.

[43] 96 DTC 1850.

[44] 99 DTC 5362.

[45] 2001 DTC 5533.

An alternative to instalment payments over time may be to undertake a reorganization of the share capital of the corporation, pursuant to section 86, in order to convert the common shares held by the vendor into fixed value preference shares which would be retractable over time pursuant to a schedule. Cumulative dividends may be paid on the outstanding shares. A taxable dividend would arise to the extent that the redemption price exceeded the paid-up capital of the shares. A capital gain may also arise to the extent that the proceeds (net of the dividend) exceed the adjusted cost base of the shares. If the shares are held by a holding company and the deemed dividend exceeds the holding company's proportional share of the operating company's post-1971 retained tax earnings, the excess may be treated as a capital gain rather than a dividend.[56]

Earn-Outs

The vendor may agree to be paid out of the future profits of the company. The vendor may sell his shares and receive a minimal amount on closing (perhaps equal to the book value of the shares). The balance of the purchase price may be computed as a percentage of gross or net profit over a period of years.

Interpretation Bulletin IT-426R, "Shares Sold Subject to an Earnout Arrangement", dated September 28, 2004, sets out the position of the CRA with respect to the taxation of an earn-out. Although paragraph 12(1)(*g*) could apply to include in income all payments under an earn-out in the vendor's income,[57] the CRA will accept the cost recovery method (i.e., first payments are considers to be tax-free recovery of cost to extent of cost) of reporting a gain or loss where the following conditions are met:

(a) the parties must deal at arm's length;[58]

(b) the gain or loss must be of a capital nature;

(c) the earn-out feature must relate to the goodwill element of the purchase price which cannot reasonably be expected to be agreed upon at the date of the sale;

(d) the duration of the sale agreement cannot exceed five years, so that no part of the capital gain can be deferred beyond five years; and

(e) in the year of sale, the vendor should submit with his tax return a copy of the sale agreement as well as a letter requesting the cost-recovery method.

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[56] See section 55.

[57] Interpretation Bulletin IT-462, "Payments based on production or use", dated October 27, 1980.

[58] A planning consideration for drafters and other advisors is that all or most of the shareholders of many private corporations in Canada are family members, who are related to one another by birth, adoption or marriage/common-law partnership. Thus, this condition may be a crucial limitation in the ability of shareholders to use this buy-sell structure successfully. Readers are referred to the earlier discussion on related persons in this Chapter.

The amounts that become determinable under the earn-out formula are treated as capital gains. The cost-recovery method would enable the vendor to report the determinable capital gain over a period of five years. The capital gains reserve will be available for the portion of the capital gain not due until after the end of the year. The reserve will be limited to 4/5 of the determined capital gain in the year of sale, 3/5 of the determined gain in the second year, and so on.

Reverse Earn-Out

In situations where the cost-recovery method is not available or is not desirable, it may still be possible to structure the transaction as an earn-out, setting a sale price of the shares and a maximum amount equivalent to the fair market value of the shares at the time of the sale, but which can be subsequently decreased if certain conditions related to sales, production or use are not met in the future. Such a structure, known as a reverse earn-out, will be treated by the CRA as being on account of capital "if there is a reasonable expectation at the time of disposition of the property that the conditions will be met . . . if subsequently, the conditions are not met then an appropriate adjustment will be made in the year in which the amount of the reduction and the sale price is known with certainty and will not vary in the future. Whether there is a reasonable expectation that conditions will be met is a question that is determined on the facts of the particular situation."[59]

Minimizing the Value of the Company Prior to the Buy-Out of a Shareholder by Annually Distributing the After-Tax Profits

This arrangement is particularly attractive where the shares of the operating company are held by holding companies, each of which owns more than 10 per cent of the voting and equity shares of the operating company or which are part of a related group that controls such a company. Such dividends would not normally be taxable to the holding companies. If the corporation requires the funds, they may be loaned back to the corporation and possibly be secured by corporate assets. This approach has the added benefit of protecting corporate profits from unsecured creditors. It may make the company more attractive as a purchaser would not be required to purchase redundant assets.

Utilizing the Retained Earnings of the Corporation to Fund the Purchase

This may be accomplished by causing the operating company to purchase the shares held by the vendor for cancellation . On a purchase for cancellation of shares, the interest expense relating to the redemption proceeds in excess of the paid-up capital should not be deductible, based on the CRA's stated position with respect to this issue.[60]

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[59] See paragraph 9 of Interpretation Bulletin IT-462, "Payments based on production or use", dated October 27, 1980.

[60] See paragraph 245(5)(*a*).

$40,000 minimum tax exemption in addition to the capital gains exemption.[17] The federal tax rate for alternative minimum is 15%.[18] Alternative minimum tax paid in excess of ordinary tax is eligible to be carried forward seven years and deducted against regular tax payable in a particular future year in excess of the alternative minimum tax liability in respect of that future year.[19]

As discussed, if an individual has a cumulative net investment loss (CNIL), the capital gains exemption may not be available in the year. For example, the individual may have carrying costs with respect to passive investments, losses from limited partnerships, resource deductions from flow-through shares and rental losses. The CNIL account may create a timing problem in that the full capital gains exemption may not be available in the year. However, the CNIL account does not eliminate but only defers access to the capital gains exemption to the extent of the CNIL balance. In addition, the CNIL account may be reduced or eliminated by earning additional investment income. Note that if the taxable capital gain is great enough (for example, equal to the aggregate of the CNIL account and $375,000) the full capital gains exemption can still be claimed.

There are also restrictions where an individual has previously claimed an allowable business investment loss (ABIL).[20]

There are also various specific anti-avoidance rules which may deny the capital gains exemption otherwise available. For example, if a corporate reorganization is accomplished by means of a butterfly and a share sale is contemplated, then the capital gains exemption could be denied pursuant to subsection 110.6(7). The purpose of subsection 110.6(7) is to prohibit a capital gain from being eligible for the capital gains exemption where the gain was realized as part of a series of transactions to which the butterfly exception in paragraph 55(3)(*b*) would apply, or where a "wingless butterfly" is effected at transfers of property below fair market value.

Pursuant to this subsection, the exemption may also be denied where an individual has a capital gain on a disposition as part of a series of transactions in which property is acquired by a corporation or partnership for consideration that is significantly less than the fair market value of the property.

Pursuant to subsection 110.6(8), the capital gains exemption may be denied where it is reasonable to conclude that a significant part of the capital gain is attributable to the fact that dividends were not paid on a share (other than a "prescribed" share) or that the dividends were less than a certain calculated amount. Common shares and certain shares properly issued in the course of a typical "estate freeze" or "employee freeze" will generally qualify as "prescribed shares" and are, therefore, outside the scope of this anti-avoidance rule. Nevertheless, the manner in which a corporate reorganization is

[17] Paragraph 127.53(1)(*a*).

[18] Clause 127.51(A).

[19] Paragraph 120.2(1)(*a*).

[20] See Interpretation Bulletin IT-484R2, "Business Investment Losses", dated November 28, 1996.

implemented or the terms of a shareholders' agreement could inadvertently cause shares to taint the prescribed share status of shares.[21]

Planning Opportunities

As discussed above, the corporation has to meet various "active business" tests in order for its shares to qualify as qualified small business corporation shares. If the company has met the "more than 50% active business test" in the prior 24 months but does not currently meet the "all or substantially all" test in order to qualify as a small business corporation, it may be possible to reorganize holdings so that the shares do qualify as shares of a qualified small business corporation. Tax practitioners refer to this type of planning as "purifying" the corporation.

Assume that a holding company has owned the shares of a small business corporation for more than two years. The fair market value of the assets of the holding company is $115,000, comprising $15,000 of investments and $100,000 representing the shares of the small business corporation. The fair market value of the assets of the small business corporation is $200,000 and the liabilities are $100,000. Assuming that more than 50% of the assets of the holding company are invested in shares of a connected small business corporation at all times, and assuming the subsidiary has met the "all or substantially all" test during this period, it is possible to reorganize the holding company prior to a sale so that the capital gains exemption would be available on the sale of the shares of the holding company.

One alternative would be to have the holding company pay a dividend in kind to its shareholders. This would result in a fair market value disposition to the holding company and may trigger a taxable dividend to the shareholder. Alternatively, the small business corporation may be wound up on a tax-deferred basis into the holding company pursuant to subsection 88(1) of the Act. As it is the assets rather than the liabilities which are determinative for the small business corporation test, Holdco would qualify as a small business corporation. It would, after the wind up, have $200,000 of assets used in an active business and only $15,000 of passive investments. A third alternative would be for the holding company to "rollover" its investments to the small business corporation in consideration for common shares.

It may be advantageous for shareholders to "crystallize" the capital gains exemption. That is, the shareholders can reorganize their shareholdings to trigger a capital gain even though there are no current plans to sell shares to a third party. One reason for crystallizing the capital gains exemption is to obtain the benefit of increasing the adjusted cost base of the shares immediately, since it is possible that the Minister of Finance may eliminate the capital gains exemption in the future. Another reason for crystallizing is to increase the cost base of the shares at a time when the shares qualify for the capital gains exemption, since it may not be easy to purify the corporation at a later date, as would be the case, for example, where the shareholders undertake a

[21] See section 6205 of the Regulations, which sets out the rules relating to whether a share is a prescribed share for this purpose.

The corporation is subject to tax on the taxable portion of the capital gain. The tax rate will depend on the status of the corporation as well as the applicable provincial tax rate. For CCPCs and investment income, there is an additional tax of 6⅔% which may be refunded once sufficient taxable dividends are paid by the corporation.[37] The purpose of this additional tax is to prevent Canadian residents from realizing a tax savings or deferral by realizing capital gains through a holding company rather than personally.

An amount equal to 26⅔% of the taxable capital gain would generally be added to the "refundable dividend tax on hand" ("RDTOH") of the vendor corporation, assuming the corporation qualifies as a CCPC throughout the year. The corporation would be entitled to a dividend refund equal to one dollar of RDTOH for every three dollars of taxable dividends paid.[38] Taxable dividends received by individuals who are shareholders would be eligible for the gross-up and credit mechanism.[39] Through the capital dividend account, RDTOH and dividend gross-up and credit mechanisms, the theoretical result is that the effective overall tax rate is approximately the same whether the capital gain is realized by a Canadian-resident individual personally or through a CCPC. This concept is known as "integration". Because individual and corporate tax rates differ from province to province, there are differences in the actual effective tax rate that would apply and the individual tax rate is rarely, if ever, identical to the effective tax rate on capital gains realized by a CCPC. As well, as described above, corporations are not entitled to the $750,000 capital gains exemption.

¶225 Tax Implications for Purchaser of Shares

The purchaser should be entitled to deduct the interest expense on funds borrowed to purchase common shares from the vendor (although comments below should be noted). If the purchaser wishes to pay the purchase price out of the earnings of the operating company, a new corporation could be formed to acquire the shares from the vendor. If the vendor does not deal at arm's length with the purchaser, section 84.1 may deem the vendor to receive a dividend rather than a capital gain.

The new corporation could borrow funds from a bank to finance the purchase. After the purchase is completed, the new corporation could be amalgamated with the operating corporation on a tax-free basis so that the amalgamated company could incur the interest expense and discharge the bank loan out of its operating profits. The CRA has indicated that the general anti-avoidance rule would not be applied to the formation and amalgamation described above (see Information Circular IC88-2, "General Anti Avoidance

[37] Section 123.3.

[38] Section 129. See Interpretation Bulletin IT-243R4, "Dividend Refund to Private Corporations", dated February 12, 1996.

[39] Note that investment income, including taxable capital gains, does not increase the general rate income pool ("GRIP") of a CCPC so that an eligible dividend cannot be paid from such investment income. If, however, the holding company already has a GRIP balance, the payment of a taxable dividend would result in both a dividend refund to the corporation and an eligible dividend to the shareholder.

Rule", dated October 21, 1988, at example 19). One consequence of this plan is that the adjusted cost base of the shares acquired from the purchaser would disappear on the amalgamation, although a "bump" in the adjusted cost base of non-depreciable capital property owned by the target company may be available pursuant to paragraph 88(1)(*d*) of the Act. Another consequence of amalgamating the purchaser and target corporation is that the provincial capital tax liabilities may be increased after the amalgamation.

It should be noted that any comments made herein with respect to interest deductibility are subject to proposed changes to such rules announced by the Department of Finance on October 31, 2003.[40] At the time of writing, it is not clear whether these rules will be enacted as currently drafted.[41] Indeed, the interest deductibility rules under the Act have been in a state of flux since the early 1990s. The recent proposals are largely a legislative response to certain Supreme Court of Canada decisions where taxpayers have been successful. The proposed legislation requires that to claim a loss, the taxpayer must assess annually the expected profitability of the business. In addition, income or loss from a business does not include capital gains or losses. As the rules will likely continue to change, it is prudent for a taxpayer to review the applicable rules in any year where interest expense will be incurred.[42]

On a straight purchase of shares by an existing shareholder, the adjusted cost base of the shares to the purchaser would be based on an average of all identical shares owned by the purchaser.[43] Unless the purchaser forms a new corporation in the manner outlined above, the purchaser will be using after-tax dollars to pay for the shares of the vendor (assuming no insurance funding). The purchaser acquires the shares with the same paid-up capital of the shares regardless of the purchase price, with the result that the funds could not be distributed from the corporation to the individual without incurring a tax liability. However, subsequent to the purchase, the purchaser could transfer the shares to a new holding company for either debt equal to the value of such shares or for shares of the new holding company with paid-up capital equal to the adjusted cost base. Section 84.1 will not apply in such situations unless the purchaser purchased the shares from a non-arm's-length person and that person claimed the capital gains exemption or a capital gains reserve or where the shares were owned prior to 1972. The funds could then be paid as a dividend from the operating company to the holding company, permitting the holding company to either repay the debt owed to the purchaser or make a tax-free return of paid-up capital, thereby allowing the purchaser to receive

[40] Proposed section 3.1.

[41] In CRA Document No. 2006-0177371M4, April 25, 2006, the Minister of National Revenue stated that the Department of Finance continues to receive submissions on the draft legislation and intends to address the concerns raised prior to enacting it.

[42] The current position of the CRA is set out in Interpretation Bulletin IT-533, "Interest Deductibility and Related Issues", dated October 31, 2003.

[43] Section 47. See Interpretation Bulletin IT-387R2, "Meaning of "Identical Properties"" (Consolidated), dated July 14, 1989.

agreement. Another one of many requirements is that the non-compete must be granted to an arm's-length party and the parties must file an election.

The rules will also apply in the context of non-resident shareholders who grant restrictive covenants. In circumstances where ordinary income treatment under subsection 56.4(2) would otherwise apply to Canadian residents, proposed paragraph 212(1)(*i*) will require withholding tax at 25% of the payment made to the non-resident, subject to reduction under the terms of any applicable income tax convention.[94]

As noted, these restrictive covenant rules have not been enacted into law and have been the subject of considerable comment and criticism. The rules as proposed are extremely complex and may be subject to further revision before being enacted. The elective exceptions noted above will need to be carefully reviewed and transactions structured to fall within these exceptions. A careful review of the rules as finally enacted will be necessary whenever transactions involve restrictive covenants.

In situations where it is not possible to avoid the application of the rules, significant valuation issues may arise as the CRA and taxpayers attempt to grapple with the value of any particular restrictive covenant. For example, suppose a shareholder receives shares as partial payment on the sale of his company. Suppose that the shares received are subject to an escrow period where the shares cannot be freely traded for some period of time or perhaps the shares are held by the purchaser as security for payment of indemnities under the sale agreement. In these situations, the vendor of the operating company shares has granted a restrictive covenant governed by section 56.4 and will require an income inclusion unless excepted under one of the exceptions in subsection 56.4(3). If not excepted, the CRA can apply section 68 to reallocate the proceeds because the exceptions to the application to section 68 will not apply, as these restrictive covenants are not in relation to non-competition. The difficulty then becomes determining the value attributable to these restrictive covenants. The normal valuation methodology applicable to valuing a non-competition agreement[95] may not easily be applied to other restrictive covenants and could be the source of protracted future litigation.

A retiring allowance is defined as an amount received as a consequence of death or on or after retirement of a taxpayer from an office or employment in recognition of the employee's long service, or in respect of a loss of an office or employment of a taxpayer, whether or not received as damages for wrongful dismissal.[96] It may be possible for an employee to transfer certain retiring allowance amounts to an RRSP free of tax. This will only apply if the employee was employed with the employer prior to 1996. There is also an annual limit of

[94] See Moody, *supra*, note 84, for a further discussion of the potential application of these rules to non-residents.

[95] *Ibid.* The approach suggested in the case of non-competition agreements includes a measurement of the value of the business with the non-competition agreement and the value of the business on the assumption that an agreement was not granted.

[96] Subsection 248(1) definition "retiring allowance".

$2,000 for every year of employment prior to 1996, plus up to an additional $1,500 for each year of employment before 1989 (subject to certain other limitations where there is a company pension plan).[97]

In many private companies, both the shareholder and his or her spouse receive a salary. A retiring allowance should be considered wherever possible, as the payment would generally be deductible to the corporation, making the payments and tax deferred to the recipient (i.e., until funds are withdrawn from the RRSP). For example, on the purchase for cancellation or sale of shares of a corporation, a retiring allowance could be paid by the corporation in the year of sale. Where the shareholder is to remain for a period of time pursuant to a contract of employment, the retiring allowance could be incorporated into the contract and could be paid on the termination thereof.

As an alternative to a retiring allowance, a departing shareholder may be paid a consulting fee. Such a fee would not be eligible for a direct transfer to an RRSP, although it would constitute earned income. If the departing shareholder, in fact, ceases to be an employee, the corporation would not be required to withhold tax.

Care must be exercised to ensure that a retiring allowance or a consulting fee not be perceived by the CRA as a reduction in the purchase price for the shares, in which case there is a risk that the deduction to the corporation would be challenged by the CRA as being unreasonable or as not constituting a retiring allowance.

In cases where a shareholder becomes disabled, the shareholders' agreement may provide for disability payments to be made to such shareholders. Such payments are generally subject to tax. Note that, unlike life insurance proceeds, proceeds from disability insurance do not form part of the capital dividend account.

¶265

Non-Resident Vendor

It should be noted that there are additional tax considerations where the vendor is a non-resident. If the buy-sell agreement is in respect of shares of a private company, such shares would be taxable Canadian property, requiring a clearance certificate from the Minister of National Revenue under section 116 in respect of any disposition thereof.[98] In the absence of a clearance certificate, the purchaser is required to withhold and remit generally 25% of the purchase price (or the fair market value in some cases) to the CRA. Failure to comply will result in penalties to the purchaser. This requirement would apply to both the sale of shares as well as a redemption or purchase for cancellation of shares.

[97] Paragraph 60(*j*.1).

[98] See Information Circular IC72-17R5, "Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada — Section 116", dated March 15, 2005.

a guaranteed source of funding. At times, the preferred funding option may determine which buy-sell structure is chosen, while in other instances, the funding structure is only one consideration examined by the shareholders in their decision-making process. Once the preferred funding option is selected, steps should be taken to ensure that the funding will be in place when it is required. Then the buy-sell agreement can be drafted to incorporate the terms of the preferred funding option.

¶315 Funding from Outside the Corporation Cash on Hand

As noted in Chapter 1 — General Contents of Shareholders' Agreements, in rare instances, the purchasing shareholder may have sufficient cash on hand to personally finance the share purchase. This funding option has the virtues of being simple and not requiring any proactive steps to be taken by either the selling or purchasing shareholder.

It should be noted that the shareholders of private corporations frequently sign personal guarantees for the corporation's liabilities. When a shareholder dies, the surviving or remaining shareholders may be called upon to use personal resources to meet those obligations, which may limit the purchaser's ability to use cash on hand to fund the buy-out.

However, the most significant drawback of this funding option is that few shareholders actually have enough cash on hand at the time the buy-sell is triggered, which makes this perhaps the least viable method of funding a buy-sell agreement.

Sale of Assets

Like using cash on hand to finance a buy-out, the sale of assets to create a cash pool to fund the purchase has significant drawbacks. First, in the case of an individual shareholder considering this option, he or she must have valuable assets available to be liquidated on a timely basis. This means that the sale depends on the nature and value of property owned by the purchaser at the time of the buy-out. In the case of a corporation considering this funding option, an asset sale may not be possible, especially if the primary assets are required for the daily operation of the business. Second, the purchaser would also have to pay the cost of disposing of the assets, including any capital gains tax arising on the disposition of capital property.

This funding option cannot be used successfully if the purchaser does not own assets at the time the buy-out is triggered having sufficient value, net of disposition costs, to finance the purchase, or if the assets are illiquid or cannot be disposed of in a timely manner.

Sinking Fund Financing

The shareholders may choose to create a fund from which the purchase price will be paid when the buy-sell triggering event occurs based on the value

of the corporation. Annual deposits are made to the "sinking fund" with the intention that the annual deposits plus the income and growth due to the investment of the sinking fund will be enough to finance the purchase of shares.

The sinking fund option means that there must be a periodic valuation of the shares of the corporation in order to ensure that the amounts being set aside are sufficient, with growth over time, to fully fund the buy-out.

There are several disadvantages to using a sinking fund. First, there is always the risk that a shareholder may die prematurely or retire unexpectedly — at a time when the funds which have been set aside are inadequate. Even with regular share valuations, it is unlikely that the value of the corporation on the death of a shareholder will be more than the value of the sinking fund, leaving the purchaser to find a way to make up the shortfall.

Second, the value of a sinking fund held within a corporation means that the sinking fund is considered on a share valuation — unless the shareholders' agreement expressly states that such fund is excluded. As a result, in the absence of such exclusion, the corporation's sinking fund will never be enough to fully fund a share purchase. For example, assume that Opco's fair market value is $1,000,000 and there are two equal shareholders. Over time, Opco's sinking fund accumulates the requisite $500,000 which is earmarked for the purchase of the shares of a deceased shareholder. However, since the sinking fund is an asset of the corporation, the shares of Opco will now be worth $1,500,000. The fair market value for 50% of Opco's shares will, therefore, be $750,000, which means the purchasing shareholder will have a shortfall of $250,000 in funds.

Third, creditors of an individual shareholder or of the corporation may be able to bring a successful claim against a sinking fund held by an individual or a corporation. A sinking fund held inside a corporation is an asset of the corporation and therefore subject to the claims of the corporation's creditors. In the case of individuals, the sinking fund would also be deemed to be a personal asset and in addition to exposure to creditors, may be the subject of a successful claim by a spouse or former spouse under the pertinent matrimonial property legislation.

Finally, a corporation's sinking fund will be considered to be a passive asset because it is not used by the corporation in the course of business. As noted in Chapter 2 — Tax Considerations — *Inter Vivos* Buy-Outs, when the passive assets of a corporation exceed 10% of the corporation's value, there is a significant risk that the shares will no longer qualify for the $750,000 lifetime capital gains exemption available to the holders of shares of a private corporation.

When examined in the context of a holding company structure (with Holdco owning all of the shares of Opco), the use of a sinking fund approach may provide mixed outcomes. On the death of a shareholder, the holding company could purchase the deceased's shares using after-tax corporate dollars that have accumulated within the holding company (which are generally

If the disability buy-sell provision is based on an immediate redemption of all of the shares of the disabled shareholder, the shareholder faces the fiscal hardship of having the full amount of the dividend on redemption being subject to tax in the year in which the sale of the shares occurs. A staged redemption (using a section 51 or section 86 reorganization converting common shares into preferred shares, for example) of a disabled shareholder's shares by the company over a number of years would avoid this problem because the deemed dividend resulting from the redemption of shares would be spread over the redemption period. The influence that the disabled shareholder or the shareholder's personal representatives might exert as a shareholder could be detailed in the shareholders' agreement.

When redemption of shares on disability takes place, the remaining shareholder will not receive an increase in the adjusted cost base of the remaining shares. The purchase and cancellation of the shares of a disabled shareholder by the company results in a reallocation of the intrinsic share value among the remaining shares. For example, assume that the two shareholders of Opco each own 50% of the issued shares. If the fair market value of Opco's shares is $1,000,000 with an adjusted cost base of nil, when one-half of the shares are purchased for cancellation using the disability insurance, the aggregate value of the post-redemption shares in the hands of the remaining shareholder is $1,000,000 instead of $500,000, but the adjusted cost base remains at nil. When the remaining shareholder disposes of the shares, the "pregnant" capital gain has been increased by $500,000.

Inter Vivos Funding Using Cash Values within a Life Insurance Policy

A corporation owning cash-value life insurance on the life of a shareholder may opt to access the policy value during the lifetime of the insured shareholder.

The corporation may elect to take a policy loan[18] against the cash value in the policy from the insurance carrier. The loan proceeds can then be used to fund an *inter vivos* buy-out. The corporation may borrow any amount up to the adjusted cost basis of the policy on a tax-free basis. The adjusted cost basis of the policy is reduced by the amount of the loan. Amounts borrowed from the policy over the policy's adjusted cost basis[19] are considered to be a partial disposition of an interest in a life insurance policy under subsection 148(9) and will be included in the corporation's income in the year the policy loan is taken. If, however, the amount in excess of the adjusted cost basis is repaid within the same calendar year as the policy loan was taken, there will be no

[18] This arrangement is more accurately described as an advance against the death benefit payable under the policy — an important consideration as the legal formalities are not the same as taking out a loan from a financial institution. Thus, the terms "policy loan" and "borrow" are used for convenience only. See David Norwood & John P. Weir, *Norwood on Life Insurance Law in Canada*, 3rd ed. (Toronto: Carswell, 2002), at p. 128 for a lucid and brief review of "policy loans".

[19] Readers should note that the tax cost of a life insurance policy is referred to as "adjusted cost basis" in subsection 148(9) of the *Income Tax Act* (Canada) unlike the definition "adjusted cost base", which is used to describe the tax cost of other property.

income inclusion. When a policy loan is repaid, the policy's adjusted cost basis is replenished. The insurance carrier is entitled to receive interest on the amounts borrowed from the policy.

Whenever the life insured dies while there is an outstanding policy loan against the policy, the insurance carrier is entitled to full repayment from the death benefit. From a practical perspective, the insurance carrier will issue a cheque to the corporation as the designated beneficiary in an amount equal to the death benefit minus the value of the outstanding policy loan together with any accrued interest payable on the policy loan. It should be noted that under the provisions of the *Civil Code of Québec*, taking out a policy loan will not affect any existing beneficiary designation in place at the time of the policy loan or on the date of death of the person whose life is insured.

Alternatively, the corporation may opt to use the accrued cash value of the policy as collateral for a loan or line of credit from a financial institution.[20] This arrangement is often referred to as "leveraging the policy." Under current tax rules, the loan from the financial institution is received on a tax-free basis, while a policy loan from the insurance carrier may not be. In addition, the corporation may be able to deduct a portion of the interest expense under paragraph 20(1)(*e*.2) if the loan arrangement can be characterized as being for business or investment purposes.[21] To qualify, the policy must be assigned to the financial institution as collateral for the loan. The collateral assignment of the life insurance policy must also be a condition of the loan.

In the common-law jurisdictions in Canada, the collateral assignment of a life insurance policy does not result in any limitation being placed on how much of the death benefit can be credited to the capital dividend account. In effect, the corporation receives the entire amount of the death benefit as the designated beneficiary and uses a portion of the death benefit to pay the loan. However, the amount of the death benefit in excess of the policy's adjusted cost basis may still be credited to the capital dividend account.

In Quebec, the use of life insurance as collateral for a loan results in the creation of a movable hypothec. The movable hypothec does not require the actual transfer of policy title to the lender. To be enforceable, the insurer must receive a notice of hypothecation of a right resulting from the insurance contract. Instead, the lender is granted a security interest in the death benefit up to the amount of the loan.

At the date of the writing of this Chapter, the law in Quebec remains unresolved about whether an individual can enter into a movable hypothec for a personally owned life insurance policy. This is because a valid movable hypothec must be "with delivery," which means that the lender is to receive physical possession of the property governed by the movable hypothec. It is unclear whether an individual policy owner can provide full delivery of the life insurance policy.

[20] See Norwood & Weir, *supra*, note 18, at pp. 369–371 for a discussion of collateral assignment of life insurance policies.

[21] See Interpretation Bulletin IT-309R2, "Premiums on Life Insurance Used as Collateral", dated February 28, 1995.

Tax planning strategies to avoid or minimize an adverse valuation determination by the CRA include:

- *Owning the life insurance through a holding company.* The life insurance is owned by each shareholder's holding company, rather than the operating company. When the interest in the operating company is disposed of, the life insurance policy will not have to be transferred as part of the transaction.
- *Split dollar ownership.* The shareholder owns the rights to the cash surrender value, while the corporation owns the death benefit. The transfer of the corporation's interest in the death benefit can usually been done without attracting tax consequences.[43]
- *Payment of life insurance policy as a dividend.* This in-kind dividend will result in a disposition by the corporation, with tax being due on the income inclusion (cash surrender value minus adjusted cost basis), if any. Unless the shareholder is a holding company, this will be a taxable dividend for the transferee shareholder, but tax will be paid at dividend rates, rather than ordinary marginal rates. If the corporation has refundable dividend tax on hand, a dividend refund will be available. Caution, however, is advised, as the CRA may deem the value of the transferred policy to exceed its cash surrender value as noted earlier. If this occurs, the greater value will be used to compute the income inclusion to the corporation on the transfer and the amount of the dividend to the shareholder.
- *Purchase of the policy at fair market value.* A shareholder may purchase the life insurance policy at its fair market value, which is generally the policy's cash surrender value. This approach is not, however, recommended when the shareholder is ill and not expected to recover, as the CRA may deem the fair market value to be in excess of the cash surrender value or even an amount approaching the policy's face amount.

¶355 Life Insurance and Share Valuation[44]

Under paragraph 70(5)(*a*), the deemed disposition of all shares owned by a shareholder occur immediately prior to death and, if the shares are not transferred to a surviving spouse or common-law partner (or a trust for the benefit of the surviving spouse/common-law partner), any increase in the value of the shares over their adjusted cost base will be subject to capital gains tax. If the full value of the death benefit of corporate-owned life insurance were included in the share valuation, it would artificially inflate the value of the shares.

To deal with this possibility, subsection 70(5.3) was enacted to impose a deemed disposition of property on (i) the death of a taxpayer, for deaths occurring after December 1, 1982, (ii) the departure of a taxpayer from

[43] See Glenn R. Stephens, *Estate Planning with Life Insurance* (Toronto: CCH Canadian Limited, 1999), at pp. 82–85, for a discussion of split dollar insurance.

[44] See Chapter 4 — Buy-Outs on Death beginning at page 142 for a further discussion of valuation issues.

Canada, and (iii) property owned by a trust on the death of a spouse or in respect of the 21-year cycle.[45] This provision deems the value of the life insurance policy on the life of the deceased shareholder immediately prior to death be the policy's cash surrender value as determined in accordance with subsection 148(9).

For the purpose of determining the cash surrender value of a corporate-owned life insurance policy on the death of a shareholder, subsection 148(9) provides that the cash surrender value is to be calculated without reference to outstanding policy loans, any policy dividends payable as of the date of death, and any interest payable upon policy dividends that are payable but not paid as of the date of death. The CRA has also determined that prepaid premiums and dividends left on deposit with the insurance carrier do not form part of the policy's cash surrender value. However, the value of the assets represented by outstanding policy loans, unpaid dividends, and the interest thereon, along with the value of prepaid premiums and dividends on deposit, will be additional assets of the corporation and may affect the value of the shares of a corporation that is the owner and beneficiary of the policy. In other words, the policy on the life of the deceased shareholder may not have a value limited to the policy's cash surrender value.

Because the effect of the provisions in subsection 70(5.3) are limited to the valuation of the life insurance policy on the life of the deceased shareholder, other valuation issues arise when there are two or more shareholders and corporate-owned life insurance was acquired to fund the buy-sell agreement. On the death of a shareholder, the value of the life insurance policies on the lives of the surviving shareholders must also be determined. As set out in Information Circular IC89-3,[46] factors to be considered in determining the value of such policies are the cash surrender value of the policy, the policy loan value, the face value, the life expectancy of the insured shareholder based on mortality tables, and the known state of health of the insured life insured shareholder. If the life insured shareholder is known to be terminally ill or was critically injured and is not expected to recover, the CRA takes the position that the value of the policy might be as high as the face value of the policy.

If the death of a healthy individual occurs suddenly, the CRA has conceded that the insurance would have little added value over its cash surrender value. This position is consistent with the reasoning of the Federal Court of Appeal in *Mastronardi v. The Queen*, [47] which held that the share valuation for income tax purposes had to occur "the instant before death." In the *Mastronardi* case, the death of the insured shareholder was sudden and unexpected. Accordingly, since the insurance proceeds would not be receivable at that time, the death benefit was not to be included in the share valuation. The CRA has

[45] Under subsections 104(4)–(5.2), imposition of the 21-year deemed disposition rule can be deferred for trusts that are solely for the benefit of the spouse or common-law partner of the settlor of the trust or the testator whose death gives rise to the trust.

[46] See IC89-3, "Policy Statement on Business Equity Valuations", paragraph 40 and the discussion above in the section "Transfers of Life Insurance Policies", dated August 25, 1989.

[47] 77 DTC 5217 (F.C.A.); see also *Geltman Estate v. R*, 2002 UDTC 285; [2003] 1 CTC 2641; 2002 DTC 3932.

provide for the purchase by the surviving shareholders of the shares held by the deceased.

Alternatively, the shareholders' agreement could provide for a put/call option arrangement whereby the shares of the deceased could be left to the surviving spouse or a qualifying spousal trust[1] under the deceased's Will. The shareholders' agreement would then grant the surviving spouse (or qualifying spousal trust) the right to put the newly acquired shares to the surviving shareholder as well as give the surviving shareholder the right to call the shares from the surviving spouse (or qualifying spousal trust) at the price stipulated in the agreement.[2] The agreement would further provide that if the deceased did not have a spouse, the option arrangement would not apply and the deceased's estate would be required to sell the shares to the surviving shareholder.

The life insurance proceeds would be paid to the survivors to be applied towards the purchase price of the shares of the deceased. If several shareholders are involved, the arrangement may be simplified by involving a trustee who would collect and discharge the insurance premiums, receive the insurance proceeds, and pay the insurance proceeds to the estate in consideration for the shares of the deceased.

Tax Implications for the Estate

If the shareholders' agreement provides for the put/call arrangement in respect of the deceased's spouse or spousal trust, the tax implications for the estate will depend on whether the shares are eligible for a rollover on death because such shares are left to the deceased shareholder's spouse or a trust for such spouse's benefit that qualifies as a "spousal trust".[3]

If the shares are eligible for the spousal rollover on death, there would be no deemed disposition on death.[4] However, the spouse or spousal trust would acquire the shares at the adjusted cost base to the deceased.[5] The subsequent sale by the spouse or spousal trust of the shares under the terms of the

[1] The requirements for a spousal rollover on death are set out in subsection 70(6) and generally apply where the deceased transfers property on death to a spouse or common-law partner resident in Canada immediately before death or to a trust created under the deceased's Will, where the spouse or common-law partner is entitled to all of the income of the trust during the spouse's lifetime and no one other than the spouse is entitled to the capital of the trust during the spouse's or common-law partner's lifetime and the property has become indefeasibly vested in the spouse, common-law partner, or trust within 36 months of the death of the deceased.

[2] This put/call arrangement is necessary to ensure that the shares of the deceased shareholder can be transferred on a tax-free rollover basis to the surviving spouse (or qualifying spousal trust) under subsection 70(6). Absent this option arrangement, the subsection's requirement that the shares vest indefeasibly in the spouse (or qualifying spousal trust) will not be met because of the fact that the shareholders' agreement requires the deceased shareholder to sell its shares to the survivor such that the shares cannot vest in the spouse (or qualifying spousal trust).

[3] See note 1, above, for the requirements of such a trust.

[4] Subsection 70(6). See Interpretation Bulletin IT-305R4, "Testamentary Spouse Trusts", dated October 30, 1996.

[5] Paragraph 70(6)(*d*).

shareholders' agreement would give rise to a capital gain to the extent that the purchase price exceeds the adjusted cost base of the shares.[6] If the purchase price is payable over time, the capital gains reserve may be available to defer the tax over a period not exceeding five years.[7] Assuming that there was adequate life insurance, the price would be paid in full on closing and no reserve would be available or required.

If the shares of the corporation held by the deceased qualify as shares of a qualified small business corporation, the estate could elect not to have the rollover apply to shares having an accrued gain equal to the unused capital gains exemption of the deceased shareholder, so as to fully utilize such exemption.[8] The balance of the shares may then be rolled over to the deceased's spouse who would claim his or her own capital gains exemption on the actual sale of shares. If the shares were owned by a spousal trust, the trust may designate that a portion of the trust's capital gain that is eligible for the exemption be treated as earned by the spouse directly for purposes of claiming the spouse's capital gains exemption.[9]

If no spousal rollover is available, there would be a deemed disposition of the shares immediately prior to death for their fair market value at that time.[10] The unused capital gains exemption of the deceased may be used to reduce or eliminate the taxable capital gain arising from the deemed disposition. The estate would be deemed to acquire the shares for an adjusted cost base equal to the deemed proceeds.[11] Assuming that the shares are then sold for a price equal to the increased adjusted cost base, no additional gain or loss will arise. The estate may pay the tax arising as a result of the deemed disposition over a period of ten years.[12] The tax would be subject to interest and the placement of adequate security with the CRA.

Tax Implications for the Survivor

The surviving shareholder or shareholders would not be taxable on the receipt of the insurance proceeds under an exempt policy.[13] The full amount of

[6] Paragraph 40(1)(*a*).

[7] Subparagraph 40(1)(*a*)(iii). Interpretation Bulletin IT-236R4, "Reserves — Disposition of Capital Property", dated July 30, 1999 (Archived).

[8] Subsection 70(6.2).

[9] The requirements for claiming the capital gains exemption are set out in section 110.6 and generally require that the shareholder claiming the exemption meet a holding period test for the shares and that the corporation meet an asset test for the period. There is also a related test, which could be a problem where all the beneficiaries under the deceased's Will are not limited to a related group. In cases where the shares are held by a spousal trust, there are provisions which permit, in certain circumstances, the beneficiary of the trust to claim the exemptions which are set out in subsections 104(21), (21.2) and 110.6(12).

[10] Paragraph 70(5)(*a*).

[11] Paragraph 70(5)(*c*).

[12] Subsection 159(5).

[13] The definition of "disposition" in subsection 148(9) excludes such a payment from constituting a disposition. Subsection 148(1) provides for an income inclusion only where there has been a disposition. Paragraph 56(1)(*j*) includes in income an amount required by subsections 148(1) or (1.1).

company does not receive a refund of refundable dividend tax on hand ("RDTOH"), there should be no income tax to the holding companies on receipt of the dividend under the Act.[20] On the death of a shareholder, the holding company of the survivor would receive the insurance proceeds and use the insurance proceeds to purchase the shares of the operating company owned by the holding company of the deceased.

Tax Implications for the Estate

If the shareholders' agreement provides for a put/call arrangement in respect of the deceased's spouse[21] or spousal trust, and a spousal rollover is otherwise available, there would be no tax on the death of the shareholder of the holding company.[22] Instead, the shares of the holding company would be acquired by the spouse or the spousal trust for a cost equal to the adjusted cost base to the deceased.[23] On the actual sale of shares of the operating company by the deceased's holding company to the survivor's holding company, a capital gain would be realized. As the capital gain would be realized by a company, the capital gains exemption would not be available. The non-taxable portion of the capital gain would be added to the capital dividend account of the deceased's holding company and would be eligible for tax-free distribution as a capital dividend.[24] A portion of the corporate tax payable on the capital gain equal to 26⅓% of the taxable capital gain would be included in the RDTOH account of the corporation and would be eligible for a refund on the payment of sufficient taxable dividends.[25]

If no spousal rollover is available, the deceased would be deemed to dispose of his shares of the holding company at their fair market value immediately prior to death.[26] If the shares of the corporation qualify as shares of a qualified small business corporation, the capital gains exemption may be available to shelter part of the taxable gain. Assuming that the holding company has never held property, other than the shares of the operating company which was a small business corporation, then the $750,000 capital gains exemption would be available. The estate would be deemed to acquire the shares of the holding company for a cost equal to their fair market value immediately before the death of the taxpayer.[27] If the sole asset of the holding company were shares of the operating company, the deemed proceeds would be based on the fair market value of the shares of the operating company owned by the holding

[20] There should also be no tax under Part VI.1 of the Act, provided that the dividends are paid on shares that do not fall within the definition of taxable preferred shares.

[21] The put/call arrangement is discussed in ¶405 of this chapter.

[22] Subsection 70(6).

[23] Paragraph 70(6)(*d*).

[24] Subsections 89(1) and 83(2).

[25] Subsection 129(1).

[26] Paragraph 70(5)(*a*).

[27] Paragraph 70(5)(*b*).

company.[28] The holding company of the deceased would also realize a capital gain on the sale of the shares to the holding company owned by the survivor pursuant to the shareholders' agreement, assuming that the purchase price exceeded the adjusted cost base of the shares. The tax-free portion of the capital gain realized by the deceased's holding company would be added to its capital dividend account and would be eligible for distribution to the estate or beneficiary (i.e., the shareholder) as a tax-free capital dividend.[29] The remaining portion of the capital gain would be subject to tax in the holding company at a rate of approximately 48.7%.[30] A portion of the corporate tax payable on the capital gain equal to 26⅓% of the taxable capital gain would be added to the RDTOH account of the holding company, which would be refunded to the holding company on the payment of a taxable dividend.[31]

Dealing with Double Taxation

If no spousal rollover is available on the death of the deceased, there is a potential for double tax. The deceased may have a tax liability arising from the deemed disposition of the shares of the deceased's holding company on death.

The holding company may also have a tax liability arising from the sale of the shares of the operating company to the survivor's holding company under the shareholders' agreement. To avoid or minimize such double tax, consideration can be given to the estate winding-up the holding company. This can be effected either before or after the sale of the shares of the operating company by the deceased's holding company to the survivor's holding company, but must be completed in the deceased's estate's first taxation year.[32] Alternatively, the estate can reorganize the shareholdings of the deceased's holding company prior to the sale of its shares of the operating company by inserting a new company between the estate and the deceased's holding company and winding-up the deceased's holding company or amalgamating it with the new company to obtain a "bump" in the adjusted cost base of the holding company's shares of the operating company.[33]

[28] As previously noted, in this situation, consideration should be given to having the deceased's estate sell the shares of the holding company to the holding company of the surviving shareholder. The purchased holding company could then be wound up into the purchasing holding company or amalgamated with it.

[29] Subsections 83(2) and 89(1). See Interpretation Bulletin IT-66R6, "Capital dividends", dated May 31, 1991.

[30] Based on the combined federal–provincial corporate tax rates applicable in the province of Ontario as at April 2009 for a corporation in 2009. Note that the 2009 Ontario Budget proposes corporate tax rate reductions which will reduce corporate tax on investment income to approximately 44.7% by 2014. Because of these rate reductions, the effective tax rate on non-eligible dividends in Ontario will increase to 32.57% beginning in 2010.

[31] Subsections 129(3) and 129(4) and paragraph 129(1)(*a*). See Interpretation Bulletin IT-243R4, "Dividend Refund to Private Corporations", dated February 12, 1996.

[32] See below for the consequences involving the unintended loss testamentary status.

[33] See generally paragraph 88(1)(*d*) and subsection 87(11). The paid-up capital and adjusted cost base of the shares of the new company held by the estate will be equal to the adjusted cost base of the shares of the operating company, subject to any reduction under section 84.1.

However, where a corporation owns insurance on an arm's length co-shareholder of the deceased shareholder, or an arm's length non-shareholder such as an employee of the corporation, general valuation principals will be applied in considering the valuation of the deceased's shares. It should be noted, however, that it should only be necessary to rely on this provision if there is no buy-sell agreement in existence, or if the buy-sell agreement did not provide for a comprehensive determination of the fair market value of the shares.

It should also be noted that this rule will also apply in determining the fair market value of any shares owned by a trust on the deemed disposition of capital property (including shares of a corporation which owns life insurance) that occurs (i) on the death of a spouse where the trust is a qualifying spousal trust and every 21 years thereafter, or (ii) on the 21st anniversary of the settlement of most other trusts and every 21 years thereafter.

Valuation issues may also impact the possible application of the penal corporate attribution rule in section 74.4. Generally speaking, the corporate attribution rule can apply to many income splitting or estate freeze type transactions. This rule will generally not apply where the corporation is a "small business corporation". In order to be a small business corporation, it is necessary that 90% or more of the fair market value of the assets be used in an active business carried on primarily in Canada. It is possible that life insurance owned by a corporation may put the company offside in meeting the 90% active business test. The relieving provisions described above in the context of the $750,000 capital gains exemption do not apply for the purposes of the corporate attribution rule contained in section 74.4.

Most provinces, with the current exception of Alberta, British Columbia, Prince Edward Island and Newfoundland, levy a provincial capital tax on corporations located within their jurisdiction.[86] By definition, this tax focuses on the corporation's capital as reflected in its financial statements. Since corporate-owned life insurance is included on a corporation's financial statements, it may well attract capital tax liability, depending on the particular jurisdiction's method of accounting adjustment or restatement policies in respect of such items.

Ontario's Corporate Minimum Tax ("CMT") applies to a corporation's gross revenues in excess of $10 million or total assets in excess of $5 million. CMT is based upon the income reported on the company's financial statements, subject to adjustment, and taxed at a rate of 4%. Corporate-owned life insurance policies may impact CMT liability in relation to any income or loss reported on the corporation's financial statements as a result of recording the policy's cash surrender value. The 2009 Ontario Budget proposes effective for

[86] In Ontario, the capital tax was eliminated as of January 1, 2007 for corporations whose salaries and wages relating to manufacturing, processing, mining, logging, farming or fishing activities in Ontario represent 50% or more of their total salaries and wages in Ontario. For corporations whose salaries and wages in Ontario for these activities comprise less than 50% but more than 20% of their total salaries and wages in Ontario, the capital tax is reduced proportionately on a straight-line basis. Based on current proposals Ontario capital tax for all corporations will be eliminated as of July 1, 2010.

taxation years ending after June 30, 2010, to reduce the CMT rate to 2.7% and to increase the total assets and revenue thresholds to $50 million and $100 million, respectively.

Because corporate owned life insurance policies may affect the corporation's balance sheet numbers, there may be consequences in relation to the small business tax deduction available to certain Canadian-controlled private corporations. The small business tax deduction is currently reduced where a corporation's taxable capital exceeds $10 million. Where a corporation's ownership of life insurance will affect the corporation's taxable capital, reduced availability of the small business tax rate may result.

Some Other Alternatives

A variation which may solve concerns about solvency, the potential valuation problem, and the eligibility of the corporation as a small business corporation, would be to have a new corporation formed during the lifetime of the shareholders. The operating company would annually subscribe for retractable preference shares in the new corporation in an amount sufficient to fund the insurance premiums. The new corporation would be the beneficiary of the insurance policy.

The common shares of the new corporation would be owned by an *inter vivos* trust. The trustees could be the shareholders and possibly, a third party. The beneficiary of the trust would be the surviving shareholder(s) of the operating company. When the first shareholder died and therefore ceased to be a beneficiary, the trust interest of the deceased shareholder should, subject to the noted comments, not be subject to a deemed disposition on death.[87] On the death of a shareholder, the new corporation would receive the tax-free death benefit. The new corporation would then be wound-up, with an amount equal to the premiums paid returned to the operating company as the redemption price of the preference shares. The balance would be distributed as a tax-free capital dividend to the trust, assuming the appropriate election was made.[88] As the operating company is entitled only to the redemption of the

[87] Historically, the CRA took the position that the fair market value of a discretionary interest in a trust was indeterminate because the discretionary beneficiary could not be certain of receiving anything under the trust. Numerous commentators, wording of various provisions of the Act and the technical notes to various provisions of the Act all support the view that, as the fair market value of a discretionary interest in a trust is indeterminate, it must be assumed to have a value of nil. In a recent advance tax ruling, Ruling 2001–0111303 "Beneficiary added to a discretionary trust", the CRA abandoned its earlier position and instead took the position that the fair market value at any time of a discretionary interest in a trust will approximate a proportionate share of the fair market value of the trust property at that time. In our view, the CRA's position is indefensible and if the CRA maintains that position (as they appear to be doing, given similar comments in recent technical interpretations — Technical Interpretation No. 2003–0181465, "FMV of an Interest in a Discretionary Trust" — section 69(1)(*b*), dated April 3, 2003 and Technical Interpretation No. 2004–0062291E5, "Discretionary Interest in Non-Resident Trust", dated March 30, 2004) it will cause extremely inappropriate results in some circumstances. Regard should obviously be given to the CRA's new position in structuring the terms of the trust, perhaps by providing that any entitlement that a beneficiary may receive is only available upon 30 days' prior notice to the beneficiary, provided that the beneficiary is alive at the end of such notice period.

[88] See subsections 83(2), 88(2), and 69(5).

trusts can often result in affiliation in similar, although not necessarily identical, fact situations.

Paragraph 251.1(1)(*g*) provides that a person and a trust will be affiliated if the person is either (i) a "majority interest beneficiary" of the trust or (ii) would be affiliated with a majority interest beneficiary of the trust, if subsection 251.1(1) was read without reference to subparagraph (*g*).

"Majority interest beneficiary" of a trust is defined in subsection 251.1(3) as a person whose interest in either the income or capital of the trust represents, when taken together with all persons affiliated with this beneficiary, more than 50% of the fair market value of all beneficiaries' interest in either all of the income or all of the trust's capital. In determining a beneficiary's entitlement to trust income or capital, a supporting rule in subparagraph 251.1(*d*)(i) provides that if the amount of income or capital of the trust that a person may receive as a beneficiary depends on the discretion of a trustee (or other person), then the beneficiary's entitlement is determined on the assumption that the discretion has been fully exercised in favour of the beneficiary. In other words, each beneficiary of a fully discretionary trust will be considered to be a majority interest beneficiary of that trust.

"Beneficiary" is defined in subsection 251.1(3) to include a person beneficially interested in the trust. The term "beneficially interested" is further defined in subsection 248(25) in a very wide fashion to include, for example, any person who might be added as a beneficiary of the trust and who does not deal at arm's length with the settlor or any other person from whom the trust acquired property.

Any person affiliated with such a beneficiary will also be considered affiliated with the trust. Two trusts will be affiliated if the contributors to both trusts are affiliated and the beneficiaries who hold a majority of the income or capital interest in the trust are affiliated.[125]

The effect of the new affiliation rules will be to virtually always create an affiliation between an estate and a corporation controlled by a majority interest beneficiary of the estate, even where the majority interest beneficiary is not a trustee of the estate. Without further legislative amendment, therefore, the stop loss rules in subsection 40(3.6) would likely often apply to deny basic *post-mortem* planning designed to avoid double tax on death.

In order to mitigate against this result, new subsection 40(3.61) was enacted applicable to losses on dispositions after March 22, 2004. This rule will also be helpful in avoiding the stop loss that would otherwise arise in corporate purchase transactions made pursuant to shareholders' agreements. Subsection 40(3.61) applies to ensure that a capital loss will not be denied by subsection 40(3.6) to the extent the loss is realized by an estate and the estate makes an election under subsection 164(6).

Subsection 40(3.6) will still apply to the extent that the election under subsection 164(6) is not made to the full extent of the capital loss. This could arise, for example, where the estate has a capital gain which will offset a portion of the capital loss with the result that the lesser amount of the capital loss will be eligible for the subsection 164(6) election. For example, assume the deceased recognizes a capital gain of $100 in respect of shares in the operating company. Suppose further that the operating company redeems the shares for $100, with the estate recognizing a capital loss of $100. Suppose further that

[125] See paragraph 251.1(1)(*h*) and subsection 251.1(3). For more details, see Appendix 2.

the estate has other capital gains of $20 so that only $80 is available as a capital loss. In this example, the estate can only elect in respect of the $80 capital loss under subsection 164(6) with the result that subsection 40(3.6) will apply to deny the $20 capital loss to the estate. A similar result can occur if the terminal return has capital losses on other property that reduce the capital gain arising on shares of the operating company the deemed disposition.

Subsection 40(3.61), as it is currently drafted, contains a nasty anomaly that could entirely undermine the protection intended to be given by the section. The problem lies in the fact that the subsection seems to apply in an iterative fashion. Using the example above, after the estate's capital loss on the disposition of operating company shares of $100 is reduced by the $20 capital gain, the provision would then continue to apply in an iterative fashion in that now the estate would be considered, for the purpose of this rule to have an $80 capital loss that must be further reduced by the estate's $20 capital gain, resulting in only a $60 capital loss being actually available under subsection 164(6). The remaining additional $20 capital loss would continue to be denied until the full loss was denied under subsection 164(6), notwithstanding the ameliorative intent of subsection 40(3.61).[126] It is understood that the Department of Finance is aware of this drafting flaw and has confirmed that the interaction of subsections 40(3.6), (3.61), and 164(6) is not intended to produce this anomalous result. To date, however, no legislative fix has been forthcoming.

Alternatively, where the stop loss rules may apply in such circumstances, consideration could be given to either having the estate dispose of its shares on the winding-up of the corporation or of creating a new corporation to be inserted between the estate and the operating company.[127]

¶444 Tax Implications for the Survivor

The survivor increases his interest in the operating company by virtue of the elimination of the shares owned by the deceased. The survivor does not increase the adjusted cost base of his shares.

Advantages

As the insurance policy is owned by the operating company, the premiums are paid using corporate dollars. Assuming that the corporate tax rate is lower than the marginal tax rate of the individual shareholders, fewer after-tax dollars are used to discharge the insurance premiums. It is not necessary to have the company make a distribution by way of a bonus or dividends to fund the insurance premiums.

If the corporation is required by its creditors to assign term insurance as collateral security for its loans, all or a portion of the premiums may be deductible.[128]

The survivors would increase their percentage interests in the company on a *pro rata* basis as a result of the purchase for cancellation of the shares owned by the deceased.

[126] See N. Moraitis and M. Kakkar, "Potential Circularity Problem with Estate Loss Carryback" (2006) 6:3 Tax for the Owner Manager 6-7.

[127] The stop loss rule under subsection 40(3.6) does not apply where the loss arises on a disposition of the shares on a winding-up under subsection 69(5).

[128] Paragraph 20(1)(e.2).

(t) "**Time of Closing**" means 2:00 p.m. (Toronto time) or such other time on the relevant closing date as may be agreed to in writing by the vendor and the purchaser in the subject transaction.

1.2 Unless otherwise provided for herein, all payments contemplated herein shall be paid in Canadian funds, in cash or by certified cheque.

1.3 This agreement shall be governed by and construed in accordance with the laws of the Province of Ontario and the federal laws of Canada applicable therein.

1.4 In this agreement, the use of the singular number shall include the plural and vice versa, the use of gender shall include the masculine, feminine and neuter genders and the word "**person**" shall include an individual, a trust, a partnership, a body corporate or public, an association or other incorporated or unincorporated organization or entity.

1.5 When calculating the period of time within which or following which any act is to be done or step taken pursuant to this agreement, the date which is the reference date in calculating such period shall be excluded. If the last day of such period is not a business day, the period in question shall end on the next business day.

1.6 Any references herein to any law, by-law, rule, regulation, order or act of any government, governmental body or other regulatory body shall be construed as a reference thereto as amended or re-enacted from time to time or as a reference to any successor thereto.

1.7 To the extent that this agreement specifies that any matters may only be or shall be dealt with or approved by or shall require action by the Shareholders, the discretion and powers of the directors of the Corporation to manage and to supervise the management of the business and affairs of the Corporation with respect to such matters are correspondingly restricted.

1.8 If shares of the Corporation are transferred by a Shareholder to one or more members of his or its Immediate Family, it shall be a condition of any such transfer that the applicable Shareholder remain entitled to and actually exercise all rights of such Shareholder hereunder. For greater certainty, any provision of this Agreement referring to or contemplating shares held by, or the number of shares held by, a Shareholder shall (without duplication) be deemed to include a reference to shares held by, or the aggregate number of shares held by, the particular Shareholder and the members of his or its Immediate Family in each case who are Shareholders, and, for further certainty, such aggregation shall apply for purposes of matters dealing with rights and obligations to vote, purchase or sell shares (including, without limitation, as a result of the occurrence of a Sale Event (as that term is defined in Article 7 below)) as contemplated herein so that a Shareholder and the members of its Immediate Family required to purchase or sell shares hereunder shall do so at the same time.

1.9 Any reference to shares of the Corporation means shares in the capital of the Corporation, as such shares exist at the close of business on the date of execution and delivery of this agreement; provided, that in the event of a

subdivision, redivision, reduction, combination or consolidation, then a reference to shares of the Corporation shall thereafter mean the shares resulting from such subdivision, redivision, reduction, combination or consolidation.

1.10 If any Article, section or any portion of any section of this agreement is determined to be unenforceable or invalid for any reason whatsoever, that unenforceability or invalidity shall not affect the enforceability or validity of the remaining portions of this agreement and such unenforceable or invalid Article, section or portion thereof shall be severed from the remainder of this agreement.

Article 2 — Termination of Prior Agreements

2.1 All prior agreements among some or all of the parties hereto regarding the organization and affairs of the Corporation and/or the sale of any Shareholder's shares of the Corporation under certain circumstances, whether written or oral, are hereby terminated.

Article 3 — Warranties and Covenants

3.1 Each Shareholder warrants that:

(a) it is the registered and beneficial owner of that number and class of the issued and outstanding shares or securities convertible into shares of the Corporation set out opposite his name below:

Name	**Number and Class of Shares or Securities Convertible into Shares**
Holdco 1	100 Common Shares
Holdco 2	100 Common Shares
Individual	100 Common Shares

(b) the shares set out opposite each such person's name above are free and clear of all claims, liens, security interests and encumbrances whatsoever and, except as provided in this agreement, no person has any agreement or option or right capable of becoming an agreement for the purchase of any such shares and/or securities; and

(c) it is not a non-Canadian within the meaning of the *Investment Canada Act*.

3.2 Each of Holdco 1 and Holdco 2 warrants that it is a resident Canadian within the meaning of the *Business Corporations Act* (Ontario).

3.3 Principal 1 warrants that:

(a) he is the registered and beneficial owner of all of the issued and outstanding shares in the capital of Holdco 1; and

(b) such shares are free and clear of all claims, liens and encumbrances whatsoever and no person has any agreement or option or any right

Shareholder in accordance with the terms and conditions contained in the Third Party Offer. In the event that no Declining Shareholder delivers a Notice then the Declining Shareholder(s) shall be required to sell their shares of the Corporation to the Third Party in accordance with the Third Party Offer and shall be deemed to have accepted the Third Party Offer. If one or more of the Declining Shareholders delivers a Notice, then they shall be required to purchase all of the shares of the Corporation (the "**Purchased Shares**") owned or controlled by the Accepting Shareholder(s) (the "**Vendor**") at the same price per share and in accordance with the terms and conditions, except that the transaction of purchase and sale in question shall take place at the Place of Closing and at the Time of Closing on the date which is 20 days following receipt by the Accepting Shareholder of the Notice. For greater certainty, if there is only one Declining Shareholder who delivers a Notice, such Declining Shareholder shall be required to purchase all of the Purchased Shares and if there are two or more Declining Shareholders who have delivered a Notice then they shall be required to purchase in such proportions as they may agree or, failing agreement, *pro rata* in accordance with their respective fully-participating shareholdings.

10.3 If a Shareholder does not fulfil his obligation to sell or purchase as provided for herein, such Shareholder hereby irrevocably appoints the other Shareholder as his attorney (which appointment shall be continuing and shall survive incapacity of the donor of such power) to execute all such documents and to do all such things as may be necessary to either sell such Shareholder's shares of the Corporation to the Third Party in accordance with the Third Party Offer or to purchase the Purchased Shares from the Vendor pursuant to the Notice.

Article 11 — Death of Principal or Individual

11.1 Upon the death of either a Principal or Individual (the "**Deceased**"), the Shareholder of which the Deceased was the Principal, or the Individual, as the case may be (the "**Vendor**") shall sell all of the shares of the Corporation owned by the Vendor (the "**Purchased Shares**") to the Corporation and the Corporation shall purchase for cancellation from the Vendor the Purchased Shares, upon and subject to the terms and conditions hereinafter set out.

11.2 The purchase price for the Purchased Shares (the "**Purchase Price**") shall be determined in accordance with the provisions of Article 13.

11.3 If the proceeds of all insurance policies on the life of the Deceased with the Corporation named as beneficiary equals or exceeds the Purchase Price, then the Purchase Price shall be paid in full by the Corporation to the Vendor by certified cheque at the Time of Closing.

11.4 If the proceeds of all insurance policies on the life of the Deceased with the Corporation named as beneficiary is less than the Purchase Price or there are no such proceeds, then the Purchase Price shall be paid as follows:

(a) the greater of:

(i) the amount of the proceeds of all such insurance policies (up to, for greater certainty, the amount of the Purchase Price); and

(ii) 50% of the Purchase Price shall be paid by the Corporation to the Vendor by certified cheque at the Time of Closing; and

(b) the balance shall be paid in equal consecutive quarterly instalments over a period of two years from the Date of Closing, together with interest on the principal balance from time to time outstanding at a rate

per annum, calculated monthly, not in advance, both before and after default and judgment and as well after as before maturity, which is equal to the Prime Bank Rate plus two percentage points, with interest on overdue interest at the same rate. Such interest shall be payable at the same times as payments of principal, the first of such instalments of principal and interest to become due and payable one month after the Date of Closing, with interest at the aforesaid rate computed from the Date of Closing. The Prime Bank Rate shall be determined on the Date of Closing and on each payment date thereafter to apply with respect to the balance of the Purchase Price outstanding in the period until the next payment date.

11.5 The purchase of the Purchased Shares shall take place at the Time of Closing at which time the Vendor shall tender the certificate or certificates representing the Purchased Shares to the Corporation. The purchase for cancellation of the Purchased Shares shall be staged as follows:

(a) the Corporation shall purchase for cancellation at the first closing (the "**First Closing**") that number of the Purchased Shares (the "**First Tranche**") the disposition of which results in a deemed dividend for income tax purposes to the Vendor in an amount equal to the increase in the Corporation's capital dividend account (as that term is defined in the *Income Tax Act* (Canada)) resulting from its receipt of the proceeds of life insurance arising upon the death of the Deceased, if any, and as applicable, but in no event to exceed the Purchase Price for the Purchased Shares; and

(b) after the First Closing, the balance of the Purchased Shares (the "**Second Tranche**") shall be purchased for cancellation by the Corporation at the second closing (the "**Second Closing**").

11.6 The First Closing and the Second Closing shall take place at the Place of Closing at the Time of Closing on the date (the "**Date of Closing**") which is the latest of:

(a) the date which is 60 days after the date of death of the Deceased;

(b) the date which is seven days following receipt of all necessary governmental releases or approvals required to be obtained in order to effect a valid transfer of the Purchased Shares;

(c) the date upon which the Corporation receives the proceeds of insurance referred to in Article 12 and payable on the death of the