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BUY-SELL AGREEMENTS: PLANNING FOR BUSINESSES OWNED THROUGH HOLDING COMPANIES

INTRODUCTION

This is the third of three articles on buy-sell agreements. The first article discusses five of the most common ways to fund a buy-sell agreement at a shareholder's death. It also discusses buy-sell agreements with a surviving spouse, and the stop loss rules. The second article discusses different ways to implement a buy-sell agreement when the business has been incorporated, and when each business owner owns shares in the operating company. This article discusses buy-sell agreements when each owner owns the operating company through their individual holding company.

OWNERS EACH OWN A HOLDCO WHICH OWNS SHARES IN OPCO

As their business interests mature, Opco's shareholders (A and B) may incorporate personal holding companies (Holdcos) to own their shares in the business. One reason is to transfer Opco's retained earnings to their Holdcos, and thereby place those earnings beyond the reach of Opco's creditors. A and B can also hold other personal assets in their holding companies, and can use them for estate planning.

When a business owner using a holding company sells their interest in the business, they rarely sell shares in their holding company. Instead, they have their holding company sell the shares the holding company owns in the operating company. Alternatively, they have the operating company redeem the shares the holding company owns in the operating company.

The additional layer of ownership at the holding company level greatly increases the number and complexity of planning options. This article will outline some of the common choices, and will suggest additional planning options.

HOLDCO SCENARIO ASSUMPTIONS

- Shareholders A and B each own all the shares in Holdcos A and B respectively.
- Holdcos A and B each own 50% of Opco.
- Opco has a fair market value (FMV) of $2,000,000 and an adjusted cost base (ACB) and paid up capital (PUC) of nil.
- The Opco shares that Holdcos A and B own each have:
  - FMV = 1,000,000
  - ACB and PUC = nil
- A and B have:
  - a personal marginal tax rate on regular income = 50%
  - a personal marginal tax rate on dividends = 45%
- Holdco and Opco tax rate = 50%
- $1,000,000 of life insurance on each shareholder will fund the buy-sell agreement.

- Each policy is corporately owned, either by a Holdco or Opco, with a Holdco or Opco designated as beneficiary.
- The adjusted cost basis of each policy for tax purposes is nil at the time of death so that the corporate beneficiary can credit the entire insurance proceeds to its capital dividend account (CDA).

1. Cross-purchase of Opco shares by Holdco - Holdco owned insurance

In this structure:

1. The buy-sell agreement is between the Holdcos.
2. Each holding company is the owner and beneficiary of, and pays the premiums for, a life insurance policy on the life of the other shareholder. Other arrangements are possible, as discussed earlier under the article, "Buy-sell agreements: planning for incorporated businesses." For example, a trustee can hold the policies on behalf of each Holdco. The trustee can then monitor the Holdcos' obligations to ensure that the policies remain in force and premiums are paid according to an agreed formula.[1]

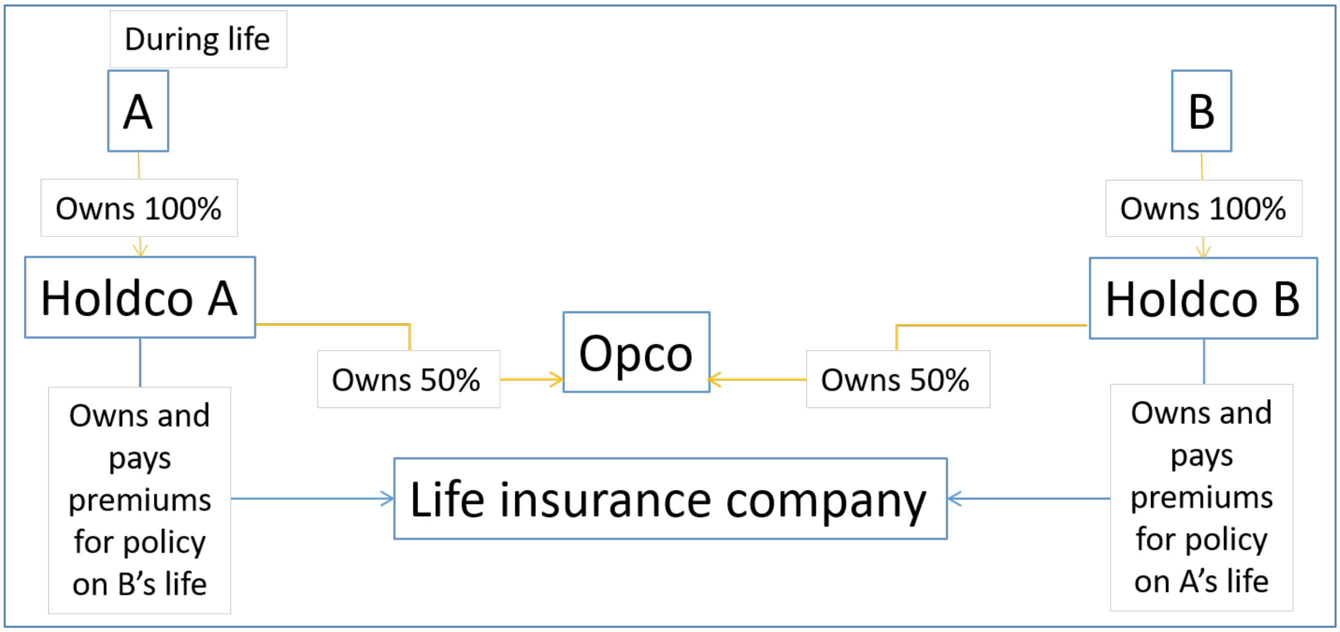
When A dies:

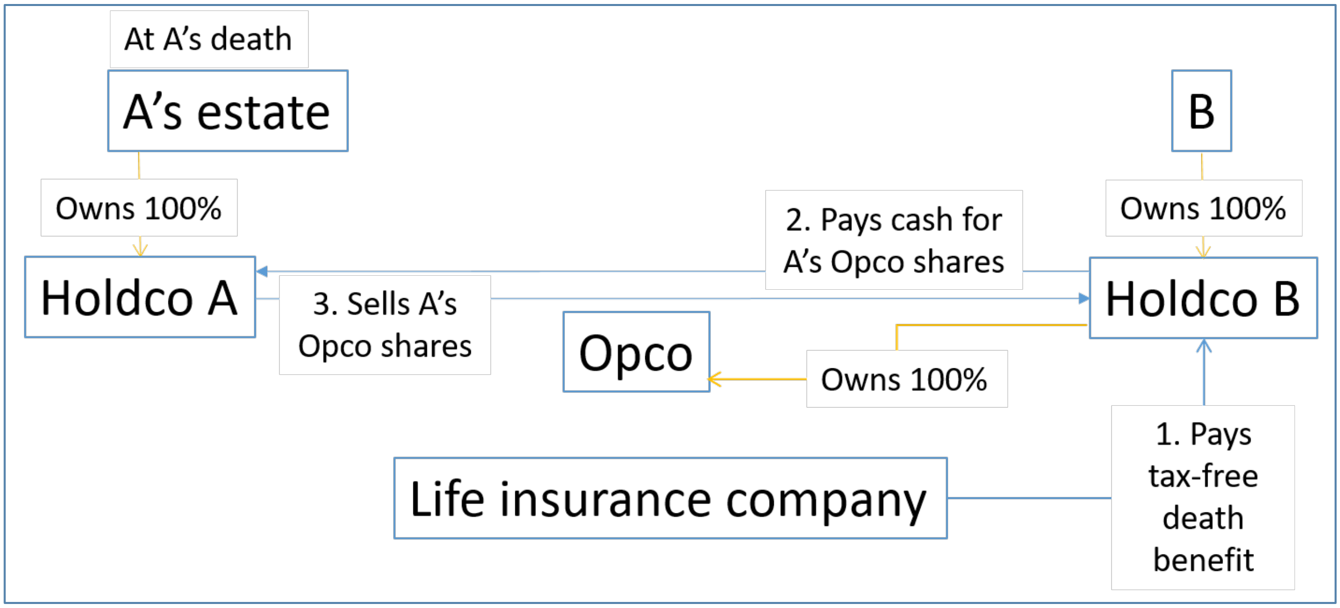
3. Holdco B receives the life insurance proceeds.
4. Holdco A sells its Opco shares to Holdco B.
5. Holdco B uses the insurance proceeds to pay for the shares.

[1] In Quebec, the framework for trusts created by the Civil Code (Civil Code of Québec, CQLR c CCQ-1991) does not permit a "bare trust" such as the arrangement described here, where a trustee holds and administers insurance policies as an agent for the parties to a buy-sell agreement. Throughout Canada, careful planning is generally advisable for a trust to avoid unintended tax costs to the trust or, by attribution, to its settlors. For example, if the trust is set up to pay the insurance premiums out of trust income, possibly from dividend-paying shares transferred to the trust, the income will be taxed at the highest personal rate: subsection 122(1). Also, if the trust is the beneficiary of the life insurance policy instead of the corporation, the proceeds on death will not qualify for a credit to the corporation's CDA.

Holdco B now owns all of Opco, and Holdco A has received FMV in cash for the shares. The buy-out takes place at FMV so that Holdco B acquires Holdco A's Opco shares with an ACB equal to the purchase price. Holdco A has a capital gain equal to the excess of the sale proceeds over the ACB (nil) of its Opco shares. A also has a capital gain from the deemed disposition of A's Holdco A shares at A's death. We consider an additional planning option below to reduce the double taxation resulting from A and Holdco A having capital gains arising from the same event.

CROSS-PURCHASE OF OPCO SHARES BY HOLDCO—HOLDCO OWNED INSURANCE





Holdco A and Holdco B pay premiums to insure B and A, respectively.

1. Insurance company pays insurance proceeds on A's life to Holdco B.
2. Holdco B pays Holdco A for Opco shares.
3. Holdco A transfers Opco shares to Holdco B.

TAX CONSEQUENCES

THE DECEASED SHAREHOLDER, A

A pays tax at death on the deemed disposition of A's shares in Holdco A.

Deemed disposition of A's Holdco A shares	1,000,000
ACB	0
Capital gain	1,000,000
Taxable capital gain (50% inclusion)	500,000
Tax payable (50% rate)	250,000

HOLDCO A

Holdco A sells its Opco shares to Holdco B. The sale results in a capital gain to Holdco A because Holdco A's proceeds of disposition exceed its ACB in the Opco shares. Holdco A can add the tax-free part of its capital gain to its CDA.

Proceeds of sale from Holdco A's Opco shares	1,000,000
ACB	0
Capital gain	1,000,000
Taxable capital gain (50% inclusion)	500,000
Tax payable (50% rate)	250,000
Addition to CDA from non-taxable part of the capital gain (50%)	500,000

HOLDCO B

Following is the summary of tax consequences to Holdco B.

ACB of Holdco B's Opco shares after purchase from Holdco A	1,000,000
ACB of Holdco B's Opco shares before purchase from Holdco A	0
Increase in ACB from buying Holdco A's Opco shares	1,000,000
Value of Holdco B's Opco shares after transaction	2,000,000
Value of Holdco B's Opco shares before transaction	(1,000,000)
Additional value of Opco shares purchased directly from Holdco A	1,000,000
Potential gain on sale or death after purchase	1,000,000
Potential gain on sale or death before purchase	(1,000,000)
Increase in potential gain on shares purchased from Holdco A	0
CDA available (from capital dividend originating in insurance proceeds)	1,000,000

Holdco B has a tax cost equal to what it paid for the new shares. No new potential gain has been created.

SUMMARY

A cross-purchase agreement between Holdcos generally favors the survivor's Holdco for at least two reasons:

1. Holdco B's ACB in its Opco shares increases by what it paid for Holdco A's Opco shares.
2. Opco can add the life insurance proceeds to its CDA to the extent those proceeds exceed the adjusted cost basis in the policy immediately before A's death (assumed to be nil in this example). If Opco elects to pay a $1,000,000 tax-free capital dividend to Holdco B, Holdco B would be able to add a $1,000,000 credit to its CDA. Since Holdco B does not need to elect capital dividend status to get the money it uses to buy Holdco B's Opco shares, Holdco B can retain the CDA to pay future tax-free capital dividends when it has the cash to do so.

ADDITIONAL PLANNING OPTION

This cross-purchase arrangement results in double taxation because A and Holdco A pay capital gains tax arising from the same event. However, A's estate can have Holdco A redeem its shares in Holdco A, using the money Holdco A received from having sold its Opco shares to Holdco B. If A's estate no longer needs Holdco A, it can achieve the same objective by winding up Holdco A. The steps would be:

1. Holdco A redeems its shares from A's estate for FMV, $1,000,000.
2. A's estate receives this money as a dividend for income tax purposes.
3. Half of this dividend is a capital dividend because half the capital gain Holdco A incurred on the sale of its Opco shares to Holdco B was a tax-free capital gain, which Holdco A added to its CDA. A's estate therefore incurs a $225,000 dividend tax liability.

4. The deemed dividend reduces A's estate's proceeds of disposition for the shares by $1,000,000 to nil.
5. Since A's estate has a $1,000,000 ACB in those shares, but is deemed to have received nothing for them, it sustains a $1,000,000 loss on the redemption.
6. A's estate carries the loss back to A's final return, thereby offsetting A's capital gain on the deemed disposition of A's Holdco A shares.
7. Effectively, this planning option eliminates the tax A had to pay on his or her capital gain - $250,000 – at a tax cost of $225,000 to A's estate. Holdco A's $250,000 capital gains tax liability does not change.

Two considerations will help determine this strategy's effectiveness:

1. To the extent Holdco A has a positive CDA balance the deemed dividend will be paid to A's estate as a tax-free capital dividend. The stop-loss rules will not apply because the CDA balance did not arise from a life insurance policy death benefit.
2. When Holdco A redeems the shares of its only shareholder, A's estate, it will be wound up unless it will issue new shares to another shareholder. The decision to wind up Holdco A will depend on several factors. Among those factors, does Holdco A own other assets that cannot be moved, or which have significant latent capital gains that would be triggered on their removal from Holdco A?

2. Cross-purchase of Opco shares by Holdco—Opco owned insurance

This structure is the same as the previous one, except that Opco, rather than the respective Holdcos, is the beneficiary of the insurance on the lives of A and B. Opco can be the policy owner, as illustrated here. As an alternative, Holdcos A and B can be the policy owners or co-owners.

In this structure:

1. The parties to the buy-sell agreement are the Holdcos and Opco.
2. Opco buys life insurance on the lives of the shareholders and pays the premiums. This could be a single policy or two policies. Opco is also the beneficiary.

When A dies:

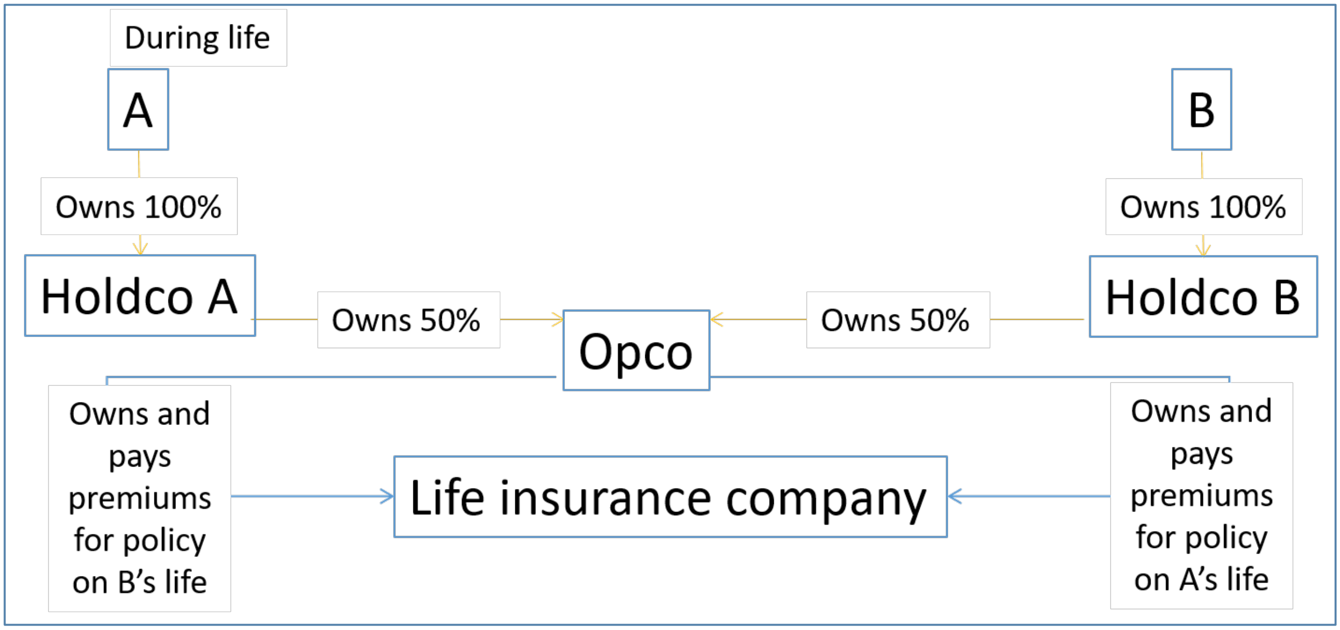
3. Opco receives the life insurance proceeds.
4. Holdco A sells its Opco shares to Holdco B.
5. Holdco B gives Holdco A a demand promissory note in exchange for the shares.
6. Now that Holdco B owns all the shares, it causes Opco to pay a dividend.
7. To the extent of the CDA created by the life insurance proceeds, Opco files an election to cause the dividend to be a tax-free capital dividend.[2] The remainder of the dividend will be taxable. Alternatively, if Opco has sufficient previously taxed surplus, it could pay a tax-free intercorporate dividend to Holdco B and retain the value of its CDA for future use.[3] Holdco B uses the proceeds of the dividend to redeem the promissory note.
8. Holdco A cancels the promissory note.

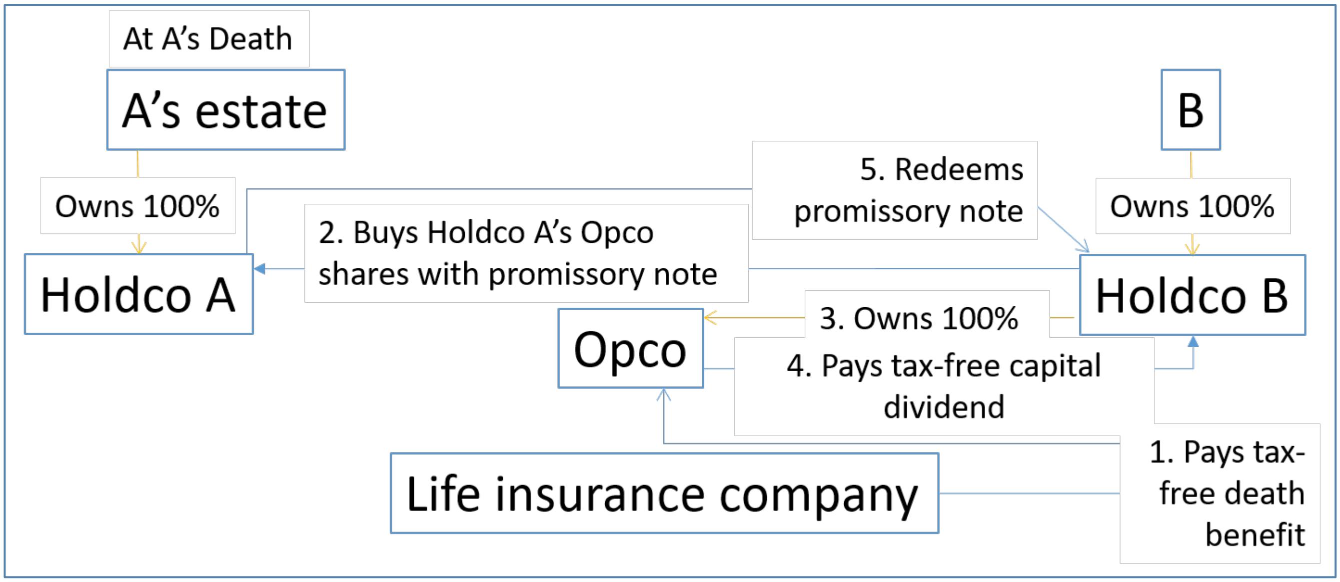
Holdco B now owns all of Opco, and Holdco A has received FMV in cash for the Opco shares it previously owned.

[2] See the section, "Implementing the 50% solution" in the second article in this series, "Buy-sell agreements: planning for incorporated businesses."

[3] Subsection 112(1) of the Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the Act. All legislative references in this article will be to the Act unless otherwise stated. The dividend amount deducted under subsection 112(l) (intercorporate dividends), offsets the dividend amount included under subsection 82(1), provided there was previously taxed surplus ("safe income") in Opco equal to the deemed dividend (see subsection 55(2)).

CROSS-PURCHASE OF OPCO SHARES BY HOLDCO—OPCO OWNED INSURANCE





Holdco A and Holdco B pay premiums to insure B and A, respectively, naming Opco as the beneficiary.

1. Insurance company pays Opco insurance proceeds on A's life.
2. Holdco B pays Holdco A for Opco shares, with a demand promissory note.
3. Holdco B, the 100% shareholder of Opco, causes Opco to pay Holdco B a tax-free capital dividend.
4. Holdco B pays cash to Holdco A to redeem the note.
5. Holdco A cancels and returns the note to Holdco B.

TAX CONSEQUENCES

THE DECEASED SHAREHOLDER, A

The consequences for the deceased shareholder do not differ from the other structures with holding companies. A pays tax only on the deemed disposition at death of the shares A owned in Holdco A. A's estate could have Holdco A redeem the shares A's estate owns in Holdco A to reduce the overall tax liability, as discussed above under the additional planning strategy.

Deemed disposition of A's Holdco A shares	1,000,000
ACB	0
Capital gain	1,000,000
Taxable capital gain (50% inclusion)	500,000
Tax payable (50% rate)	250,000

HOLDCO A

Holdco A sells its Opco shares to Holdco B, resulting in a capital gain to Holdco A because Holdco A's proceeds of disposition exceed its ACB in the Opco shares. Holdco A can add the tax-free part of its capital gain to its CDA.

Proceeds on sale from Holdco A's Opco shares	1,000,000
ACB	0
Capital gain	1,000,000
Taxable capital gain (50% inclusion)	500,000
Taxes payable (50% rate)	250,000
CDA available (from 50% non-taxable capital gain)	500,000

HOLDCO B

Following is the summary of tax consequences to Holdco B

ACB of Holdco B's Opco shares after purchase from Holdco A	1,000,000
ACB of Holdco B's Opco shares before purchase from Holdco A	0
Increase in ACB from buying Holdco A's Opco shares	1,000,000
Value of Holdco B's Opco shares after transaction	2,000,000
Value of Holdco B's Opco shares before transaction	(1,000,000)
Additional value of Opco shares purchased directly from Holdco A	1,000,000
Potential gain on sale or death after purchase	1,000,000
Potential gain on sale or death before purchase	(1,000,000)
Increase in potential gain on shares purchased from Holdco A	0
CDA available (from capital dividend originating in insurance proceeds)	1,000,000

Holdco B has a tax cost equal to what it paid for the new shares. No new potential gain has been created.

SUMMARY

The ultimate tax consequences of this structure for all involved are identical to the preceding cross-purchase strategy where the owners and beneficiaries of the insurance are the respective Holdcos.

Again, a sale of the operating company shares between the holding companies generally favours the survivor's Holdco because:

1. Holdco B's ACB in its Opco shares increases by what it paid for Holdco A's Opco shares.
2. Opco can add the life insurance proceeds to its CDA to the extent those proceeds exceed the adjusted cost basis in the policy immediately before A's death (assumed to be nil in this example). If Opco elects to pay a $1,000,000 tax-free capital dividend to Holdco B, Holdco B would be able to add a $1,000,000 credit to its CDA. Since Holdco B does not need to elect capital dividend status to get the money it uses to buy Holdco B's Opco shares, Holdco B can retain the CDA to pay future tax-free capital dividends when it has the cash to do so.

The Opco-owned cross-purchase arrangement enjoys a significant advantage over the Holdco-owned strategy. Under the Opco-owned strategy the Holdco's controlling shareholder can allocate the CDA created by Opco's receipt of insurance proceeds between Opco and Holdco. Under the Holdco-owned strategy Opco has no opportunity to get any of the CDA credit.

3. Redemption of shares by Opco—Opco owned insurance

In this structure:

1. The parties to the buy-sell agreement are the two Holdcos and Opco.
2. As in the preceding structure, Opco buys life insurance on the lives of the shareholders and pays the premiums. This could be a single policy or two policies. Opco is also the policy beneficiary.

When A dies:

3. Opco receives the life insurance proceeds.
4. Opco uses the life insurance proceeds to redeem Holdco A's Opco shares.
5. Holdco B now owns all the Opco shares.

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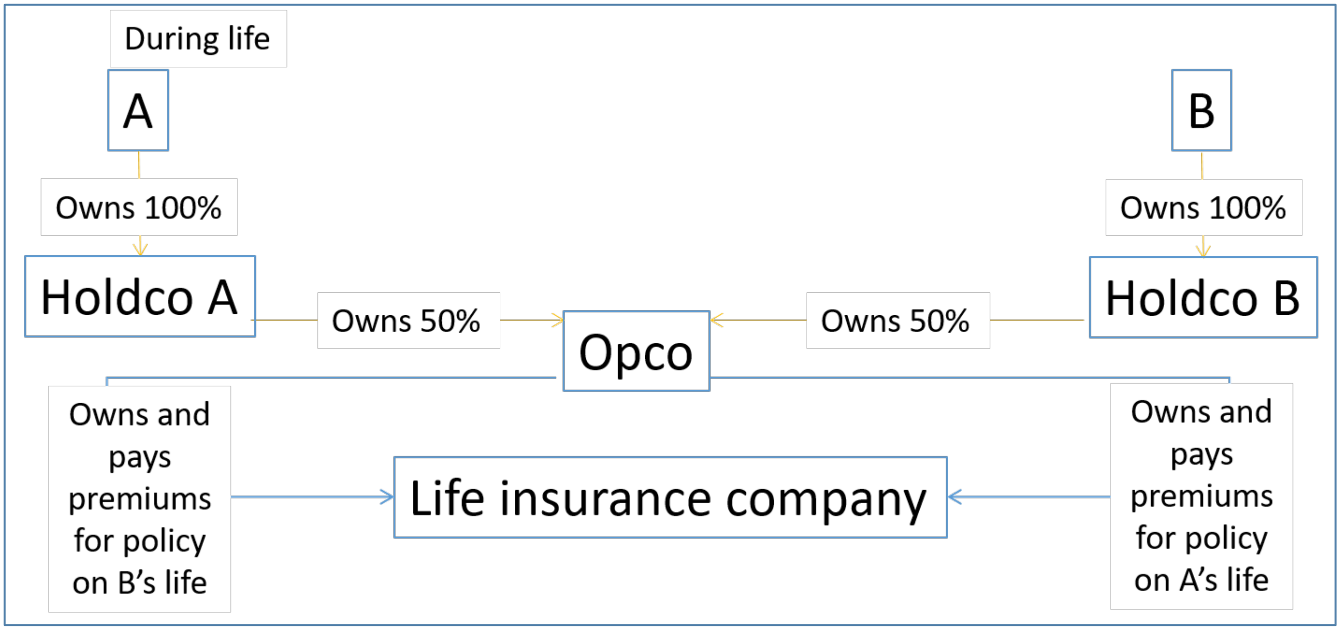
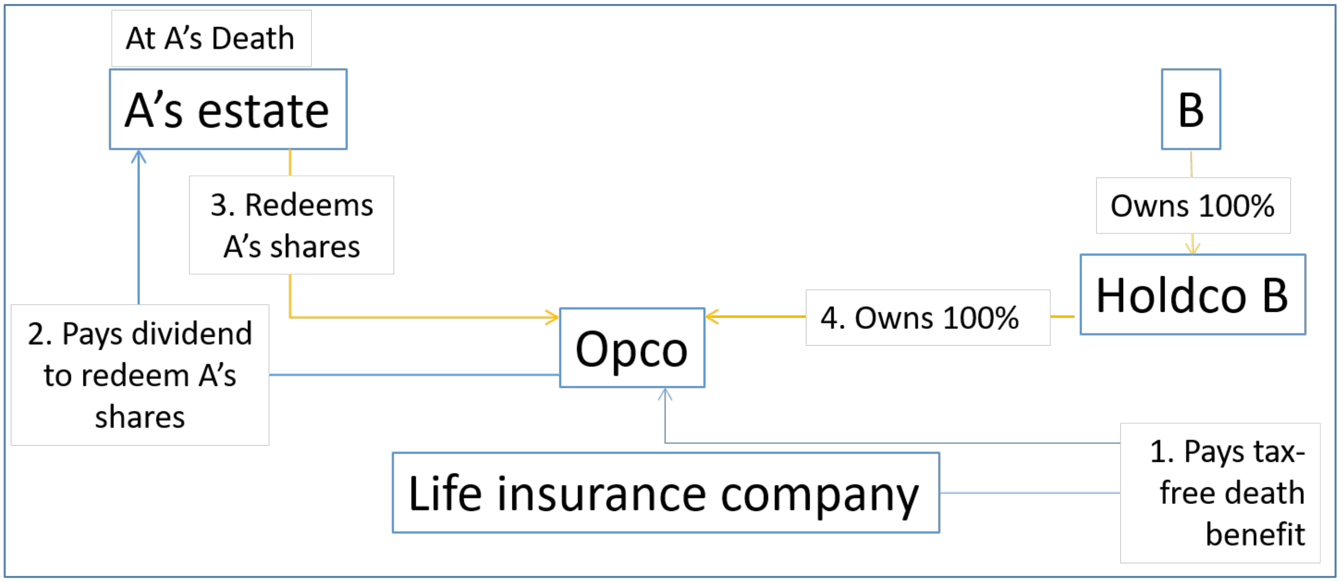
REDEMPTION OF SHARES BY OPCO—OPCO OWNED INSURANCE





Opco pays premiums to insure the lives of A and B.

1. Insurance company pays Opco insurance proceeds on A's life.
2. Opco redeems Opco shares from Holdco A, using the insurance proceeds.
3. Holdco A transfers Opco shares to Opco for cancellation.
4. Holdco B owns all the Opco shares.

TAX CONSEQUENCES
THE DECEASED SHAREHOLDER, A

Again, the tax consequences for the deceased shareholder do not differ from the other structures with holding companies. A is taxable only on the deemed disposition at death of shares in Holdco A.

Deemed disposition of A's Holdco A shares	1,000,000
ACB	0
Capital gain	1,000,000
Taxable capital gain (50% inclusion)	500,000
Taxes payable (50% rate)	250,000

HOLDCO A

Opco redeems the shares Holdco A owned in Opco. Holdco A receives the proceeds of redemption as a deemed dividend. The deemed dividend reduces Holdco A's proceeds of disposition for the shares by the same amount. The buy-sell agreement stipulates that Opco shall elect that the dividend created by the redemption is a capital dividend. The stop-loss rules don't apply because Holdco A has no right to transfer any loss arising from the redemption to A.

Portion of insurance proceeds received by Opco (proceeds deemed to be tax-free capital receipt)	1,000,000
Capital dividend election	(1,000,000)
Taxable dividend to Holdco A[4]	0
Proceeds received by Holdco A from share redemption	1,000,000
Portion deemed to be a dividend	(1,000,000)
Adjusted proceeds for purposes of calculating capital gain for Holdco	0
ACB to Holdco A of the shares	0
Capital gain (loss) for Holdco A	0

HOLDCO B

In this scenario, Holdco B acquires Holdco A's potential taxable gain. This occurs because Holdco B's interest in the business has increased without Holdco B having paid anything for that interest. There are no immediate tax consequences to Holdco B or B on Opco's redemption of its shares from Holdco A. However, since neither Holdco B nor B paid anything for this increase in share value, they do not receive an increase in the ACB of their investment. Their percentage of ownership increases in proportion to their existing level of holdings.

[4] Subsection 83(2). Some or all of this dividend could be a tax-free intercorporate dividend deductible under subsection 112(1) without the use of the CDA election, provided there was previously taxed surplus ("safe income") in Opco equal to the deemed dividend. See paragraph 55(2)(b).

ACB of Holdco B's shares in Opco after transaction	0
ACB of Holdco B's shares in Opco before transaction	0
Increase in Holdco B's ACB in Opco shares arising from Holdco A's redemption of Opco shares	0
Total value of Holdco B's Opco shares after transaction	2,000,000
Value of Holdco B's Opco shares before transaction	(1,000,000)
Additional value of Holdco B's Opco shares	1,000,000
Potential gain on sale or death after transaction	2,000,000
Potential gain on sale or death before transaction	(1,000,000)
Increase in potential gain on shares	1,000,000
CDA available for the future	0

SUMMARY

In this structure, Holdco B, and therefore B, its shareholder, acquire the latent capital gain in the Opco shares Holdco A owned. On the other hand, Holdco B, and indirectly B, have acquired the other 50% of Opco's value without paying for it.

Holdco A has no tax to pay, as it has not sold its shares in Opco. Rather, its shares have been redeemed in a transaction that creates a tax-free capital dividend. Alternatively, A's estate may be able to use a redemption or windup strategy to eliminate some of the tax on A's final tax return.

On balance, a redemption is more advantageous for A than a cross-purchase unless A has a lifetime capital gains exemption (LCGE) equal to all or most of the deemed capital gain at death. A redemption is also an attractive strategy for B as Holdco B's future tax bill from acquiring Opco is indefinitely deferred.

ADDITIONAL PLANNING OPTIONS

See comments under the earlier strategy, "Cross-purchase of Opco shares by Holdcos—Holdco owned insurance," for an additional planning option to eliminate the capital gain of the deceased shareholder by using the money Holdco A receives for the Opco shares to redeem its shares from A's estate, in effect exchanging the capital gain for a taxable dividend.

It may also be possible to eliminate the deceased shareholder's capital gain if Opco first redeems its shares from Holdco A, and Holdco A then redeems its shares from A's estate and is wound up. When Opco redeems its shares from Holdco A, the redemption proceeds would be treated entirely as a dividend for income tax purposes. Opco would file a capital dividend election in respect of this dividend and an equivalent CDA would arise in Holdco A.[5]

Holdco A would then redeem enough shares from the estate to create a loss in the estate that could be carried back to eliminate the $250,000 of tax on the capital gain reported in A's final return. To avoid triggering the stop-loss rules, a capital dividend election would be made on only half of the deemed dividend on the redemption and the remainder would be a taxable dividend.[6] The net result would be to effectively eliminate half of the tax of the deceased and to convert the other half into a taxable dividend for the estate rather than a capital gain for A.[7]

Another option would be for Holdco A to use the CDA created by the redemption of Opco shares to pay a tax-free dividend to the estate of A.

Many further variations on the preceding structures are possible but are beyond the scope of this article.

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[5] Subsections 83(2) and 89(1)(b).

[6] See the section, "Implementing the 50% solution" in the second article in this series, "Buy-sell agreements: planning for incorporated businesses."

[7] Estate planning measures would also have to be taken to avoid the stop-loss provisions in subsections 40(3.6) and (40(3.61), which prevent carrying back a loss which is greater than the loss allowed under subsection 164(6)).

	Cross-purchase Holdco-owned insurance	Cross-purchase Opco-owned insurance	Share redemption Opco-owned insurance
Deceased shareholder (A)			
Deemed disposition of Holdco A shares	1,000,000	1,000,000	1,000,000
ACB	0	0	0
Capital gain	1,000,000	1,000,000	1,000,000
Taxable capital gain (50% inclusion)	500,000	500,000	500,000
Taxes payable (50% rate)	250,000	250,000	250,000
Holdco A			
Portion of insurance proceeds received by Opco deemed to be tax-free capital receipt	n/a	n/a	1,000,000
Capital dividend election and tax-free capital dividend paid to Holdco A			(1,000,000)
Taxable dividend paid to Holdco A[8]			0
CDA increase in Holdco A			1,000,000
Proceeds received on redemption of Opco shares	n/a	n/a	1,000,000
Portion deemed to be a dividend			(1,000,000)
Adjusted proceeds	1,000,000	1,000,000	0
ACB to Holdco A of the shares	0	0	0
Capital gain (loss) for Holdco A	1,000,000	1,000,000	0
Taxable capital gain (50% inclusion)	500,000	500,000	0
Taxes payable (50% rate)	250,000	250,000	0
CDA increase (from non-taxable 50% of capital gain)	500,000	500,000	0

[8] Subsection 55(2). Some or all of this dividend could be paid tax-free to Holdco A as an intercorporate dividend without using the CDA election, provided there was previously taxed surplus "safe income" in Opco equal to the deemed dividend.

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	Cross-purchase Holdco-owned insurance	Cross-purchase Opco-owned insurance	Share redemption Opco-owned insurance
Holdco B			
ACB of Holdco B's Opco shares after transaction	1,000,000	1,000,000	0
ACB of Holdco B's Opco shares before transaction	0	0	0
Increase in ACB from direct purchase from estate	1,000,000	1,000,000	0
Total value of shares owned by Holdco B after transaction	2,000,000	2,000,000	2,000,000
Total value of shares owned by Holdco B before transaction	(1,000,000)	(1,000,000)	(1,000,000)
Additional value of shares purchased or redeemed from Holdco A	1,000,000	1,000,000	1,000,000
Potential gain on sale or death after transaction	1,000,000	1,000,000	2,000,000
Potential gain on sale or death before transaction	(1,000,000)	(1,000,000)	(1,000,000)
Increase in potential gain - shares purchased from Holdco A	0	0	1,000,000
CDA available for the future (from insurance proceeds)	1,000,000	1,000,000	0

	Cross-purchase Holdco- owned insurance	Cross-purchase Opco-owned insurance	Share redemption Opco- owned insurance
Combined tax results *A and Holdco A*			
Tax payable by A	250,000	250,000	250,000
Tax payable by Holdco A	250,000	250,000	0
Total tax payable at time of death by A and Holdco A	500,000	500,000	250,000
CDA acquired by Holdco A	500,000[9]	500,000[10]	1,000,000[11]
B and Holdco B			
Future gain acquired by Holdco B	0	0	1,000,000
CDA acquired by Holdco B[12]	1,000,000	1,000,000	0

SUMMARY

Among the three scenarios, the two cross-purchase methods may favour the surviving shareholder, B, by:

1. Increasing the ACB on Holdco B's Opco shares, thereby reducing the capital gain on a subsequent disposition, and

[9] Created by the 50% non-taxable portion of the capital gain realized on the sale of the Opco shares.

[10] Same.

[11] Created by Holdco A's receipt of a tax-free capital dividend from Opco using the CDA credit from Opco's receipt of tax-free life insurance proceeds. The intercorporate dividends retain their character as capital dividends originating in tax-free insurance proceeds provided that the paying corporation elects to treat the dividend as a capital dividend. A payment debits the CDA of a paying corporation and credits the CDA of the receiving corporation.

[12] Created by Holdco B's receipt of tax-free life insurance proceeds or a capital dividend originating in insurance proceeds.

2. Increasing Holdco B's CDA for future use by the full amount of the insurance proceeds received by Holdco B (compared with the non-taxable 50% portion of the capital gain realized by Holdco A).

The two cross-purchase options produce the same outcome. If creditor protection is a concern, there may be an advantage in the cross-purchase using Holdco-owned insurance since the insurance proceeds will never be an asset of Opco and will therefore be less exposed to Opco's creditors, unless the Holdco or its owner have guaranteed Opco's debts.

Option three, the share redemption method using Opco-owned insurance, may favour A's estate by:

1. Minimizing the tax payable by A and A's estate after A's death, and
2. Increasing Holdco A's CDA for future use by the full amount of the capital dividend received from Opco.

The balance will tilt away from the redemption solution if A had unused LCGE to offset the gain on A's Holdco shares on death, or if it is expected that the gain can be deferred for a considerable period of time by rolling the shares over to A's spouse.

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