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Buy/Sell Methods & Case Study



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Agenda

- A case study looking at the following buy/sell methods
 - Promissory Note Method
 - Corporate Redemption method
 - Hybrid method
 - Other methods
 - 50% solution under corporate redemption
 - Spousal roll and redeem


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Terms

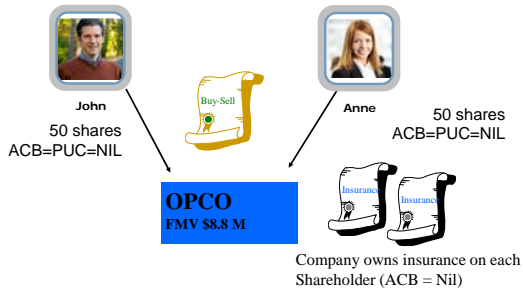
- Fair Market Value (FMV)
- Paid Up Capital (PUC)
- Adjusted Cost Base (ACB)
- Capital Dividend Account (CDA)

Assumptions

- The following examples assume shareholders deal with each other at arm's length for income tax purposes
- Shareholders have previously used \$800,000 capital gains exemption

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Fact Situation




John
50 shares
ACB=PUC=NIL

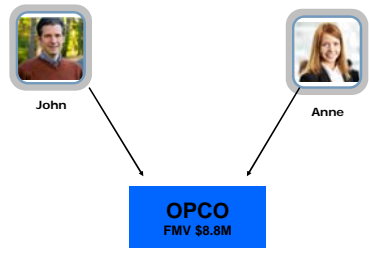
Anne
50 shares
ACB=PUC=NIL

OPCO
FMV \$8.8 M

Company owns insurance on each Shareholder (ACB = Nil)

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Promissory note method

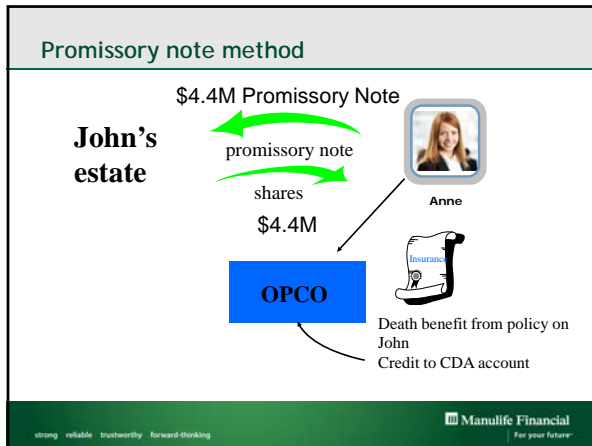


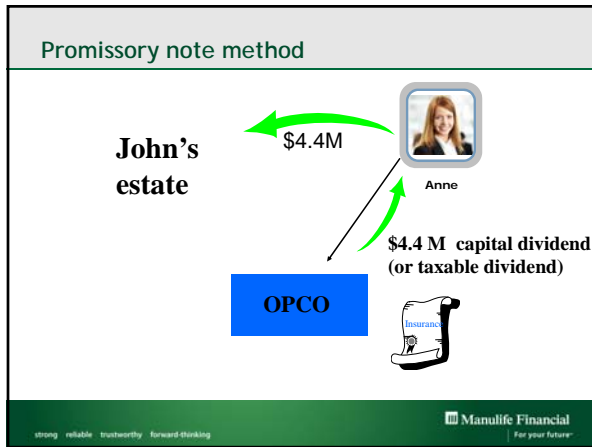
John

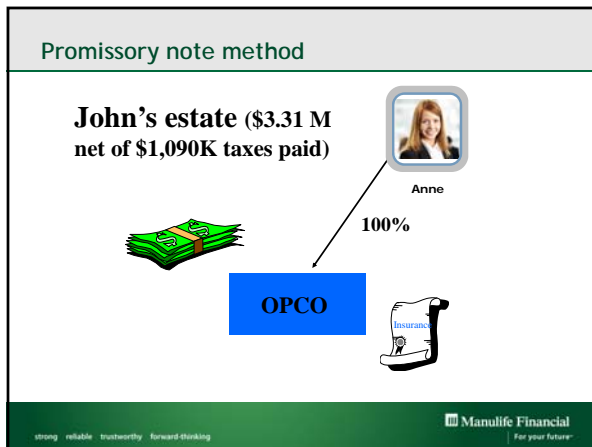
Anne

OPCO
FMV \$8.8M

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Promissory Note Method - Tax Consequences

John's terminal tax return	
Deemed Proceeds on Death ss 70(5)	\$4,400,000
Less: ACB	\$ 0
Capital Gain	\$4,400,000
Taxable Capital Gain (50% of Capital Gain)	\$2,200,000
Tax at 49.53%	\$1,090,000

Promissory Note Method - Tax Consequences

Disposition by John's Estate	
Proceeds of Disposition	\$4,400,000
Less: ACB	\$4,400,000
Capital Gain	\$ 0
Taxable Capital Gain (50% of Capital Gain)	\$ 0
Tax	\$ 0

Promissory Note Method - Results

Summary	With Insurance	No Insurance
John pays tax on Capital Gain	\$1,090,000	\$1,090,000
John's Estate Receives Net Cash	\$3,310,000	\$3,310,000
Anne owns 100% of Opco – ACB	\$4,400,000	\$4,400,000
Anne's Tax on \$7.3M Dividend	\$ 0	\$2,933,000
Anne's Future CG Tax Liability	\$1,090,000	\$1,090,000
Net CDA Remaining in Opco	\$ 0	\$ 0

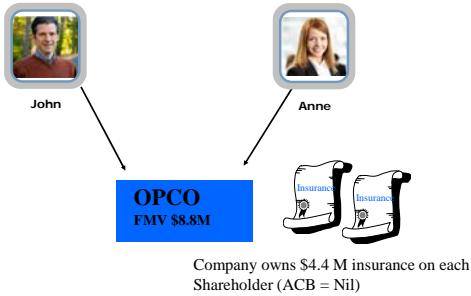
Promissory Note Method - Recap

- Pros
 - corporate-owned insurance - cost of premium is better where corporation is in lower tax bracket
 - each S/H able to verify policy is in force
 - only one policy per S/H is purchased
 - results in sharing of total insurance costs
 - purchasing shareholder gets ACB step up
 - in other situations, CGE may be available
- Cons
 - no opportunity to defer taxes to survivors of deceased shareholder

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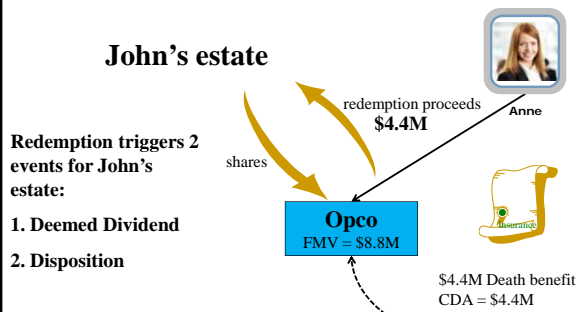
100% Redemption method



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100% Redemption Method



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100% Redemption Method - Tax Consequences to John

John's terminal tax return	With Insurance	No Insurance
Deemed Proceeds on Death ss 70(5)	\$4,400,000	\$4,400,000
Less: ACB	\$ 0	\$ 0
Capital Gain before loss carryback	\$4,400,000	\$4,400,000
Less: Capital Loss carried back from estate	\$2,200,000	\$4,400,000
Revised Capital Gain	\$2,200,000	\$ 0
Taxable Capital Gain (50% of Capital Gain)	\$1,100,000	\$ 0
Tax at 49.5%	\$ 545,000	\$ 0

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100% Redemption Method - Tax Consequences to John's Estate

Deemed Dividend to John's Estate	With Insurance	No Insurance
Proceeds of Disposition	\$4,400,000	\$4,400,000
Less: PUC	\$ 0	\$ 0
Deemed Dividend	\$4,400,000	\$4,400,000
CDA Election	\$4,400,000	\$ 0
Taxable Dividend	\$ 0	\$4,400,000
Tax	\$ 0	\$1,760,000

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100% Redemption Method - Tax Consequences to John's Estate

Disposition of Shares to Opco	With Insurance	No Insurance
Proceeds of disposition	\$4,400,000	\$4,400,000
Less: Deemed Dividend	\$4,400,000	\$4,400,000
Adjusted Proceeds of Disposition	\$ 0	\$ 0
Less: ACB	\$4,400,000	\$4,400,000
Capital Loss	\$(4,400,000)	\$(4,400,000)
Capital Loss (after stop loss rules apply)	\$ (2,200,000)	\$ (4,400,000)

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100% Redemption Method - Results

Summary	With Insurance	No Insurance
John pays tax on Capital Gain / Dividend	\$545,000	\$1,760,000
John's Estate Receives Net Cash	\$3,855,000	\$2,640,000
Anne owns 100% of Opco – ACB	\$ 0	\$ 0
Anne's Future CG Tax Liability (\$8.8 @ 24.77%)	\$2,180,000	\$2,180,000
Net CDA Remaining in Opco	\$ 0	\$ 0

Redemption method recap

- PROS
 - corporate-owned insurance - cost of premium is better where corporation is in lower tax bracket
 - each S/H able to verify policy is in force
 - only one policy per S/H is purchased
 - results in sharing of total insurance costs
 - opportunity to defer all or a portion of the tax to the survivors
 - may be able to use GRIP account balance
- CONS
 - no capital gains exemption or ACB step up
 - complexity due to stop-loss rules

Another Solution?

- Anne and John's accountant suggested another alternative:

"The 50% Solution"
- What is it?
 - Do a corporate redemption, but elect capital dividend treatment on only 50% of the deemed dividend

**50% Solution -
Tax Consequences to John**

John's terminal tax return	With Insurance
Deemed Proceeds on Death ss 70(5)	\$4,400,000
Less: ACB	\$ 0
Capital Gain before loss carryback	\$4,400,000
Less: Capital Loss carried back from estate	\$4,400,000
Revised Capital Gain	\$ 0
Taxable Capital Gain (50% of Capital Gain)	\$ 0
Tax at 49.5%	\$ 0

**50% Solution -
Tax Consequences to John's Estate**

Deemed Dividend to John's Estate	With Insurance
Proceeds of Disposition	\$4,400,000
Less: PUC	\$ 0
Deemed Dividend	\$4,400,000
CDA Election	\$2,200,000
Taxable Dividend	\$2,200,000
Tax @ 40%	\$ 880,000

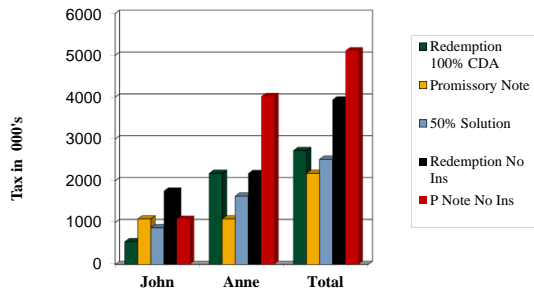
**50% Solution -
Tax Consequences to John's Estate**

Disposition of Shares to Opco	With Insurance
Proceeds of disposition	\$4,400,000
Less: Deemed Dividend	\$4,400,000
Adjusted Proceeds of Disposition	\$ 0
Less: ACB	\$4,400,000
Capital Loss	\$(4,400,000)
Capital Loss carried back to Terminal Return	\$(4,400,000)

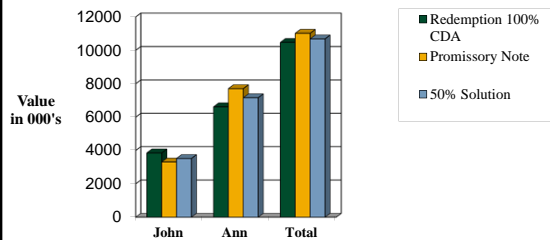
50% Solution - Results

Summary	With Insurance
John pays tax on Capital Gain	\$0
John's estate pays tax on dividend	\$880,000
John's Estate Receives Net Cash	\$3,520,000
Anne owns 100% of Opco – ACB	\$ 0
Anne's Future CG Tax Liability	\$2,180,000
Net CDA Remaining in Opco	\$2,200,000
Value of Remaining CDA @ 24.77%	\$545,000

Tax Recap




After Tax Value with Insurance



Spousal Rollover


The Strategy:

- Roll shares to John's wife on his death, then have Opco redeem the shares from John's wife

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Spousal Rollover

- Shares roll to John's wife on death
 - John's wife receives shares at the adjusted cost base
 - No capital gain in the terminal return
- Opco redeems shares from John's wife
 - John's wife receives a deemed dividend when Opco redeems
 - The dividend is paid from the CDA
 - No capital loss and therefore no stop loss

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Spousal Rollover

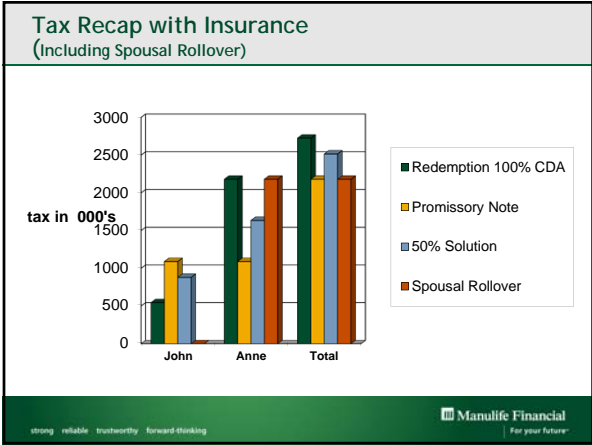
- Shares must "vest indefeasibly"
- Must ensure that the shares are not subject to a mandatory redemption clause
- Avoid "vest indefeasibly" problem:
 - Put/call option in the shareholders agreement
 - Holding company

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Spousal Rollover - Results

Summary	
John's tax on Capital Gain [70(6) rollover]	\$ 0
John's estate pays tax	\$ 0
John's Estate Receives Net Cash	\$4,400,000
Anne owns 100% of Opco – ACB	\$ 0
Anne's Future CG Tax Liability	\$2,180,000
Net CDA Remaining in Opco	\$ 0
Value of Remaining CDA @ 24.77%	\$ 0

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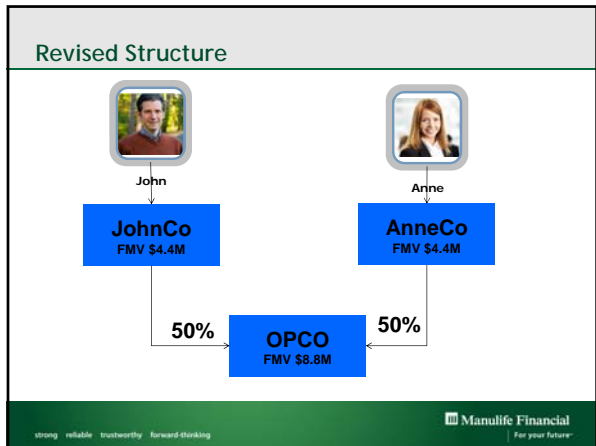


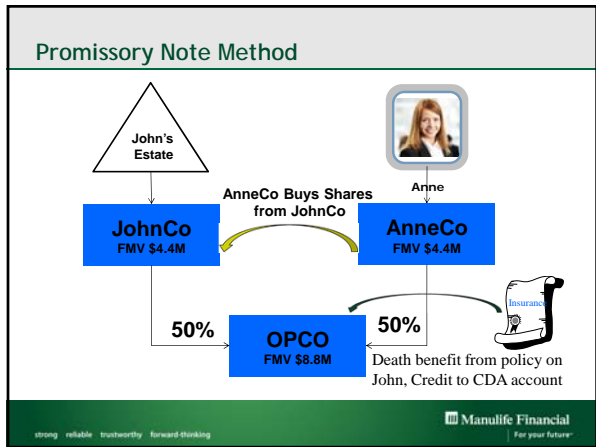
Hybrid Method

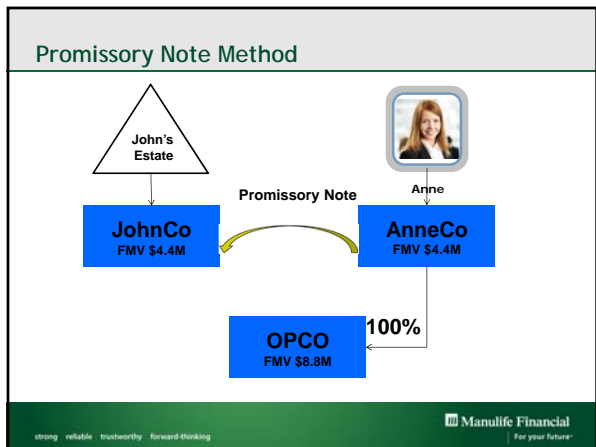
The Strategy:

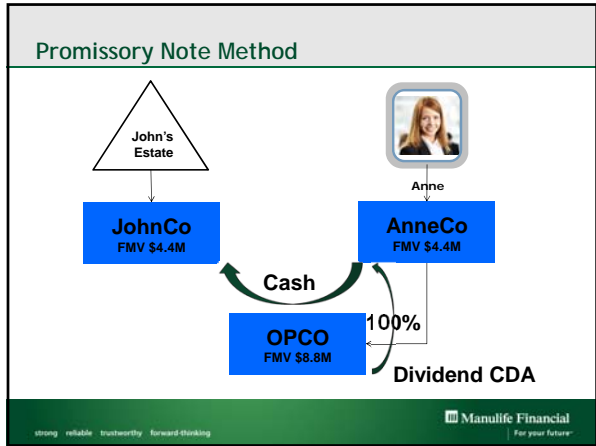
- Combination of Promissory Note and Redemption Methods
- Effective were Capital Gains Exemption available
- Can be combined with spousal rollover
- Provides flexibility

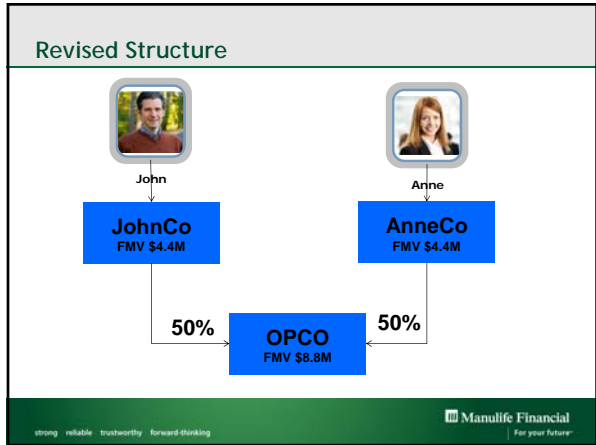
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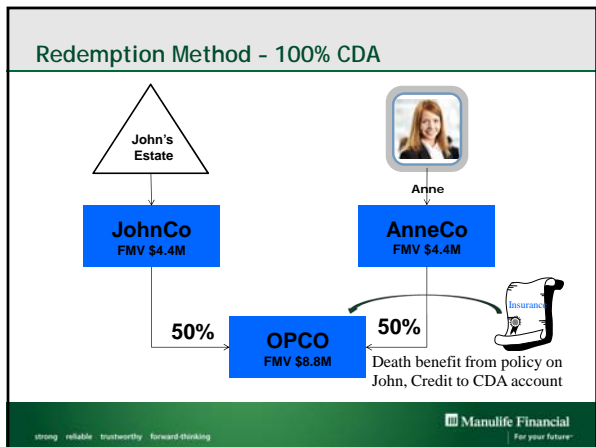


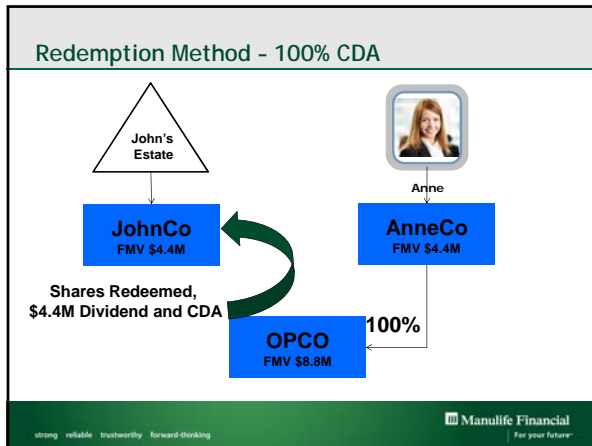












Summary of John's Estate Values

Summary	No Holdco	With Holdco
Promissory Note Method (Note 1)	\$3,310,000	\$3,263,000
Redemption – Opco 50% CDA Election (Note 2)	\$3,520,000	\$3,548,000
Redemption – Opco 100% CDA Election	\$3,855,000	\$3,855,000
Spousal Roll & Redeem – Opco 100% CDA Election	\$4,400,000	\$4,400,000


Note 1 – w Holdco \$4.4M CDA left for Anne, value \$1,090K to \$1,760K
 Note 2 - \$2.2M CDA left for Anne, value \$545K to \$880K

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- ### General Conclusions
- Timing of surviving shareholder's disposition?
 - Tax rates change!!!
 - Equity to shareholders?
 - Watch out for "most tax effective" wording
 - Consider use of a hybrid method, but no clear cut answer which will work in all or even most cases (50% solution not always best)
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Summary

- Insurance funding is always better than no funding
- Implications for drafting of buy-sell agreements
 - hybrid method gives flexibility to wait and see
 - Watch "most tax efficient solution" - for whom???
- Where appropriate don't forget spousal rollover opportunity


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Other resources



You can access the Manulife Tax and Estate Planning website from Reppsource

- Guides
 - "A guide to general insurance provisions for buy sell on death & disability"
- Tax Topics
 - "Buy/Sell Agreements – An Overview of Funding with Life Insurance"
 - "Buy/Sell Agreements – Criss Cross Purchase Method (without trustee)"
 - "Buy/Sell Agreements – Criss Cross Purchase Method (with trustee)"
 - "Buy/Sell Agreements – Promissory Note Method"
 - "Buy/Sell Agreements – Corporate Redemption Method"
 - "Buy/Sell Agreements – Hybrid Method"

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Thank you


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