

Insured shareholder agreements and the capital dividend account

Funding a buy/sell or shareholders agreement using life insurance is often the most effective and cost efficient method of providing liquid dollars to implement the deal when an owner passes. In the case of corporately owned life insurance, the proceeds are payable tax-free to the company. The company will get a credit of the excess of the death benefit over the adjusted cost basis into its notional capital dividend account. A properly executed and documented election can then serve to pay out a positive balance in the capital dividend account to shareholders. You may think that a purchase of shares or assets would automatically use tax-free capital dividends to buy that interest in the company. If it's not in writing then there is no legal obligation to do so. Take the case of Fernando Ribeiro. (Ribeiro Estate vs. Braun Nursery Limited, 2009 CanLII 1149, ONSC)

Fernando was one of several key employees who owned a minority interest in a successful nursery in recognition of their loyal service and value to the company.

When he died in 2004, the shareholders agreement obligated the company to purchase most of his shares using a \$1 Million corporately owned life insurance policy on Fernando's life. Unfortunately for the Ribeiro estate, the terms of the agreement made no reference to the capital dividend account, let alone the requirement that the company declare a capital dividend and then use tax-free monies to buy the deceased's shares. The company did not declare a capital dividend when it bought the shares from the Ribeiro estate using the life insurance proceeds. The credit in the capital dividend account remained in the company. This resulted in almost \$250,000 of income tax that the Ribeiro estate had to pay.

The estate sued for an oppression remedy against the company, arguing that the minority shareholder had been unfairly prejudiced or oppressively treated when the company did not declare a capital dividend and use tax-free monies to buy the shares within 12 months of electing to pay out a capital dividend.

The court found that the company had honoured all of the terms of the shareholders agreement and that Fernando Ribeiro did not reasonably expect the company to structure the payment to optimize the tax benefit to the estate. The court focused on the clear terms of the agreement, not the intentions of Ribeiro and the company, not



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Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He annually provides 100's of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As a Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

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what they may have talked about or forgot to include in an agreement. The estate had no enforceable right to demand that the company use the capital dividend account when using the life insurance proceeds to purchase the shares.

Here are some planning points:

- Clear documentation is required on the use of corporately owned life insurance proceeds, the use of the capital dividend account and associated income tax implications when structuring a shareholders agreement. This includes who gets to benefit from any payments coming through the capital dividend account.
- Open the doors of communication between professional advisors. This is key to understanding the best way to structure an agreement. This should serve to minimize drafting errors and omissions when preparing shareholder agreements and structuring the life insurance policies.
- Coordinate the terms, conditions and objectives of a shareholders agreement with the will and that of a Power of Attorney for Property.
- Be sure to stress test the agreement and funding amounts and types to ensure they continue to do the job they were intended to do. Situations change; relationships change; tax rules change and so do the priorities and concerns of parties to an agreement and those impacted by them.

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