iA LARGE CASE
SOLUTIONS

All the expertise.
All the products.
All our attention.

SHAREHOLDER AGREEMENT: LIFE INSURANCE, A VALUABLE TOOL IN THE EVENT OF DEATH

iA Financial Group

TABLE OF CONTENTS

SHAREHOLDER AGREEMENT OVERVIEW

A shareholder agreement (the "**Agreement**") is a contract allowing shareholders to agree in advance on internal corporate management, the relationship and the methods of resolving conflicts between shareholders and the corporation.

Corporate laws ("**Acts**" or "**Act**") establish the structure common to all corporations. An Agreement may be used to supplement certain legislative provisions to meet the specific objectives and needs of shareholders. Although voluntary, the Agreement is a valuable instrument to adapt corporate governance to the specific reality of shareholders. As soon as a corporation has more than one shareholder, an Agreement should be considered. An Agreement should be executed periodically and reviewed while there is harmony among the shareholders. Agreements usually contain numerous, varied, tailor-made provisions negotiated between the shareholders and the corporation, and are usually drafted by independent lawyers.

THE RIGHTS AND OBLIGATIONS OF SHAREHOLDERS AND THE BOARD OF DIRECTORS

Shareholders

The Act provides a limited number of rights and responsibilities for shareholders. Shareholders:

- have the right to obtain information on the corporation's financial position and to appoint auditors.
- may attend and vote at annual and special meetings of the shareholders, depending on the rights conferred on them by their shares.
- are responsible for the election of directors and the financial contribution to the corporation in exchange for shares held in the share capital.
- do not have a duty to act in the best interests of the corporation.

Moreover, shareholders, in this capacity, are not responsible for the actions of the corporation, nor for its debts, unless they have engaged their personal liability or for exceptional circumstances justifying piercing the "corporate veil".

The Board of Directors

The Act provides numerous powers, duties, and obligations for the directors of the corporation, who act through the board of directors. The board of directors:

- normally manages the business and affairs of the corporation without the need for shareholder approval, except as required by law.
- has the same duties towards the corporation as a mandatary.
- must always act independently, within the limits of its powers, with prudence and diligence, honesty, and loyalty in the exclusive interest of the corporation.

In the event of a breach of duty, directors may incur personal liability, including for unpaid employee wages, withholding taxes, consumption taxes, and environmental violations.

TYPES OF SHAREHOLDER AGREEMENTS

There are two types of shareholder agreements.

1. "Ordinary" shareholder agreements ("**Agreement**")

   They mainly include provisions relating to the relationship among shareholders, and between them and the corporation.

2. Unanimous shareholder agreements ("**USA**")

   They are different from "ordinary" agreements because of their purpose, which is to restrict the powers of directors and extend those of shareholders.[1]

UNANIMOUS SHAREHOLDER AGREEMENT

The Act establishes a separation between the shareholders' meeting and the board of directors, which must act solely in the interest of the corporation. However, it is possible for shareholders to override the independence of the board of directors and intervene directly in the administration of the corporation, by agreeing on a USA. Thus, shareholders may agree to withdraw the responsibilities of the board of directors in whole or in part, and to substitute themselves in the exercise of their powers. To qualify as a USA, all shareholders, including those without voting rights, must be parties to the agreement.

When shareholders set up a USA, it is then possible for them to agree in advance among themselves on the corporation's orientations, without necessarily having to consider only its ultimate interest. A USA may include provisions to modify voting procedures, management provisions and provisions relating to dividends to declare.

THE OBJECTIVES OF A SHAREHOLDER AGREEMENT

In accordance with the Act, the articles of incorporation and the by-laws of the corporation, the Agreement establishes rules specific to the relationship between the shareholders and the corporation to reflect precisely their situations and needs. To achieve this, the Agreement can pursue several objectives, including:

1. Maintain proportional ownership of shares among shareholders.
2. Maintain the "private" status of the corporation by preventing third parties from becoming shareholders without the consent of the other shareholders or by limiting access to the corporation's shareholding to a specified class of persons.[2]
3. Ensure a market for the transfer of shares.[3]
4. Protect the rights of minority shareholders so that they cannot be prejudiced by the decisions and actions of majority shareholders or a group of shareholders.
5. Agree in advance on a method of managing the resolution of conflicts between shareholders.[4]
6. Provide shareholders with decision-making authority over certain activities, internal[5] to the corporation (USA).

This list is not exhaustive. Shareholders should consult their lawyers to discuss the objectives of their Agreement, the potential provisions and the underlying principles. Shareholders will then be able to assess the relevance of each provision according to their needs and objectives.

[1] It is common for unanimous shareholder agreement provisions to be included in the shareholder agreement and not to be the subject of a separate agreement. This practice is not always recommended.
[2] For example, families, friends of directors or members of the corporation's senior management.
[3] For example, by forcing the conclusion of an exchange of shares in the event of death, retirement, disability, conflict, or withdrawal from the corporation's business.
[4] For example, in the event of conflict, personal bankruptcy, embezzlement or competition.
[5] For example, provisions related to the administration of the corporation: the issue or acquisition of shares, the declaration of dividends.

TYPICAL PROVISIONS OF SHAREHOLDER AGREEMENTS

To achieve the above-mentioned purposes, the Agreement and the USA may contain various provisions, provided that they respect the law and public order. Typical provisions within the Agreement and the USA include:

1. Provisions for the share transfer between shareholders, for example:
   a) The right of first refusal: this provision forces selling shareholders to offer their shares to their co-shareholders, in proportion to their ownership, before being able to sell them to a third party.
   b) the "piggyback" clause: this provision is relevant in the event of an offer to purchase the shares of a majority shareholder; it gives minority shareholders the right to participate in the offer made to the majority shareholder under the same terms of said offer:
      i) the "tag-along" clause: this provision forces a third-party purchaser to also purchase the shares of minority shareholders.
      ii) the "drag-along" clause: this provision forces minority shareholders to sell their shares to a third-party purchaser.
   c) The "shotgun" clause: this provision allows a shareholder to initiate a process of purchase of the shares of another shareholder offering two possibilities:
      i) the shareholder beneficiary of the offer accepts the offer to purchase from the offering shareholder; or
      ii) the beneficiary shareholder refuses the offering shareholder's offer to purchase and is then required to offer to the offering shareholder a counteroffer to purchase the beneficiary shareholder's shares under the same terms and conditions as the initial offer.
   d) Transfers in the event of death: this provision provides for the terms of transfer and payment of shares upon the death of one of the shareholders following the payment of a life insurance proceeds.
2. The provisions related to the transfers between shareholders, redemption by the corporation or sale to third parties.
3. Valuation of shares: this provision provides a predetermined mechanism for appraising shares in different circumstances such as withdrawal from business, disability, fraud, or gross negligence of a shareholder. There are different appraisal methods, each with its advantages and disadvantages. When determining the price of shares or an appraisal method, it is important to consider the tax impact on the selling shareholder, especially when the shareholders are related. The valuation method should be reliable, fair, indisputable, and adjusted annually, while considering the context, such as death, disability, criminal conviction, bankruptcy, or withdrawal from business.
4. Voting provisions:
   a) Election of directors: shareholders may undertake to elect each other or elect certain persons as directors.
   b) Special majority: it may be necessary to obtain a different percentage of votes for certain decisions. These resolutions may be adopted unanimously or by a greater majority (example: two thirds or 75%) to allow minority shareholders to cast their votes without paralyzing important decisions for the development of the corporation.
5. Penalty clauses: these provisions may be used in when a shareholder contravenes an Agreement clause (e.g., a non-competition clause, a provision related to the encumbrance of shares); thus, the Agreement could provide for an injunction, payment of a lump sum to the other shareholders, or abandonment of legal actions of the defaulting shareholder against the other shareholders upon receipt of a predetermined amount (whether the default is rectified or not).
6. Miscellaneous provisions: mainly for the resignation of directors, additional financial contribution, reimbursement of expenses and advances, discharges of guarantees, termination of the Agreement, notices between shareholders, dispute settlement, non-competition and non-solicitation, the obligation for new shareholders to become parties to the Agreement, and so on.

The previous list is not exhaustive. Therefore, shareholders should consult their lawyers to draft agreements adapted to their needs and objectives.

TRANSFERS IN THE EVENT OF DEATH

The surviving shareholders are generally not interested in having the estate of the deceased shareholder hold shares in the corporation after his or her death. Where appropriate, provisions on the transfer of shares in the event of death may provide a mechanism to ensure that the surviving shareholders receive the shares held by the estate, while ensuring that the estate receives a fair, determined, or determinable consideration. Such consideration should account, in particular, for the proportion of shares held by the surviving shareholders and whether or not the shareholders were dealing at arm's length prior to the death. Thus, to provide for an adequate estate transfer, the Agreement may contain transfer provisions providing for the purchase of the deceased shareholder's shares by surviving shareholders or for the redemption by the corporation.[6]

The tax consequences of a shareholder's death depend on the method used to transfer ownership of the shares (purchase by surviving shareholders or redemption by the corporation) and the use of a life insurance product, if any, to finance the transaction. Shareholders should discuss these elements in advance and establish the method to transfer the shares of the deceased shareholder in the Agreement, according to the advantages and disadvantages offered by each method of transfer.

The purchase of the shares of the deceased shareholder by the surviving shareholders results in the realization of a capital gain. When the conditions prescribed by the *Income Tax Act*[7] ("**ITA**") are met, this capital gain may qualify for a capital gain deduction ("**CGD**") of up to $971,190 in 2023[8]. Following the purchase, the surviving shareholders hold more shares, and their adjusted cost base ("**ACB**") is increased by the amount paid.

The corporation's share redemption results in a taxable dividend. The share redemption does not allow the beneficiary of the capital gain to take advantage of the CGD. Following the share redemption, the deceased's shares are cancelled, resulting in a proportional increase in the surviving shareholders' interest in the issued share capital of the corporation, without affecting the ACB of the remaining issued and outstanding shares.

In addition, depending on the value accrued on the deceased's shares, financing the purchase of the shares held by the estate may be an issue in many situations. Indeed, notwithstanding the method used to transfer the deceased's shares, it will be necessary to finance the transaction, without jeopardizing the financial health of the corporation or the surviving shareholders. Subscribing to a life insurance policy is a simple and convenient way to plan the transfer of the deceased's shares in an efficient way. For this reason, the Agreement should include provisions that require insurance coverage on the life of each shareholder to be purchased and kept in force.

Upon the death of a shareholder whose life is insured, the corporation receives a tax-free death benefit. In addition to being paid promptly, the death benefit is credited to the capital dividend account ("CDA") in whole or in part.[9] The corporation will then be able to: pay this tax-free capital dividend to the surviving shareholders so that they can acquire the shares of the deceased ("Sale")[10] or proceed with the redemption and cancellation of the deceased's shares by electing to use the CDA, so that the deemed dividend is paid as a non-taxable dividend ("Redemption"). For greater flexibility, the Agreement may allow the exercise of one of the two options to ensure optimal tax planning. The Agreement may also allow a combination of Sale and Redemption, i.e., the "hybrid" option, to have the possibility of taking advantage of the tax situation of the parties.[11]

[6] When agreeing upon an Agreement, shareholders should also consult their legal advisors to update their wills and ensure they are in line with the Agreement.

[7] See the rules surrounding the qualification of shares as Qualified Small Business Shares ("**QSBS**")

[8] This amount is indexed annually.

[9] See [Capital Dividend Account (ia.ca)] for more details on the CDA.

[10] Where persons are related for tax purposes, sellers are presumed to dispose of their shares at fair market value immediately before their death. Where shareholders are dealing at arm's length, tax authorities will generally accept the value mentioned in the Agreement or the USA.

[11] Loss carry-back rules and stop-loss rules may apply when purchasing shares and when redeeming shares.

Example:

To illustrate the differences between Sale, Redemption and the hybrid option, we assume the following situation. Opco Inc. is a Canadian-controlled private corporation carrying on a business in Canada. Ms. DEF and Mr. ABC are the equal shareholders holding common shares of Opco Inc. Opco Inc. shares qualify for the purposes of the CGD.[12] The marginal tax rate of Ms. DEF and Mr. ABC is 50%. The shares held by Ms. DEF and Mr. ABC have an ACB[13] and paid-up capital ("PUC") of $0[14] and a fair market value (FMV) of $1,000,000. Opco Inc. is the beneficiary of the life insurance policies taken out on the lives of Ms. DEF and Mr. ABC.

Upon Mr. ABC's death, the insurance company pays a death benefit of $1,000,000 to Opco Inc., which records it in its CDA. To transfer the shares held by Mr. ABC's estate, the Agreement may include two options:

1. Purchase by Ms. DEF (option 1): Opco Inc. pays a capital dividend out of its CDA to Ms. DEF who purchases the Opco Inc. shares held by Mr. ABC's estate; or
2. Redemption by Opco Inc. (option 2): Opco Inc. proceeds with the redemption and cancellation of the shares held by Mr. ABC's estate and, Opco Inc. declares and pays a capital dividend from its CDA to Mr. ABC's estate.

Mr. ABC
100 common shares
ACB = PUC = $0
FMV = $1,000,000

Ms. DEF
100 common shares
ACB = PUC = $0
FMV = $1,000,000

Opco Inc.

12 In 2023, the CGD is $971,190 (indexed annually).
13 Adjusted cost base.
14 Paid-up capital.

The following table illustrates the tax impacts of both options[15]

	OPTION 1 Purchase by Ms. DEF	OPTION 2 Redemption by Opco Inc.
Implications for Mr. ABC		
Deemed disposition of shares	$1,000,000	$1,000,000
minus the ACB	$0	$0
Capital gain	$1,000,000	$1,000,000
minus CGD	$900,000	$900,000
Net capital gain	$100,000	$100,000
Net taxable capital gain (50% of net capital gain)	$50,000	$50,000
Tax of the deceased (marginal rate of 50%)	$25,000	$25,000
Implications for Mr. ABC's estate		
Proceeds of disposal of shares	$1,000,000	–
Proceeds of share redemption (capital dividend)	–	$1,000,000
minus the deceased's tax	$25,000	$25,000
Net amount received by the estate	**$975,000**	**$975,000**
Implications for Ms. DEF		
FMV of shares	$2,000,000	$2,000,000
ACB of shares	$1,000,000	$0
Future sale (no capital gain)		
Disposition of shares	$2,000,000	$2,000,000
minus the ACB	$1,000,000	$0
Capital gain	$1,000,000	$2,000,000
minus CGD	$900,000	$900,000
Net capital gain	$100,000	$1,100,000
Net taxable capital gain (50% of net capital gain)	$50,000	$550,000
Tax (marginal rate of 50%)	$25,000	$275,000
Net amount received by Ms. DEF	**$1,975,000**	**$1,725,000**

Option 2 does not take into consideration the loss carry-back[16] rules or stop-loss rules.[17] The loss carry-back rules and stop-loss rules will reduce the net amount received by Mr. ABC's estate[18]. Clients and their accounting and tax professionals shall analyze their specific situations while considering the loss carry-back rules and stop-loss rules.

In addition to Option 1 and Option 2 mentioned above, the Agreement may also provide for a hybrid option. Following Mr. ABC's death, a hybrid option may consist of Mr. ABC's estate selling Opco Inc. shares to Ms. DEF for $900,000 and Opco Inc. redeeming and cancelling the remaining shares held by the estate for $100,000.

15 This table is presented for illustrative purposes only and is intended to illustrate the main tax consequences. Shareholders are invited to consult with their legal, accounting and tax professionals to determine the best options for share transfers on death applicable to their specific situations.

16 The legal representatives of Mr. ABC's estate may elect, within one year of the death, to exercise the election under subsection 164(6) of the ITA.

17 Subsection 112(3.2) of the ITA.

18 See Option 2: the net amount of $975,000 received by the estate will be reduced when the stop-loss rules are applied; Shareholders shall consult with their accountants and tax professionals at the appropriate time to evaluate the tax consequences of the options applicable in their specific situations.

The following table illustrates the tax impacts of Option 2[19] and the hybrid option[20] :

	OPTION 2 Redemption by Opco Inc.	HYBRID OPTION
Implications for Mr. ABC		
Deemed disposition of shares	$1,000,000	$1,000,000
minus the ACB	$0	$0
Capital gain	$1,000,000	$1,000,000
minus loss carry-back	$1,000,000	$100,000
minus stop-loss rules	$500,000	$50,000
Capital gain	$500,000	$950,000
minus CGD	–	$900,000
Net capital gain	$500,000	$50,000
Net taxable capital gain (50% of net capital gain)	$250,000	$25,000
Tax of the deceased (marginal rate of 50%)	$125,000	$12,500
Implications for Mr. ABC's estate		
Proceeds of disposal of shares	–	$900,000
Proceeds of share redemption (capital dividend)	$1,000,000	$100,000
minus the deceased's tax	$125,000	$12,500
Net amount received by the estate	**$875,000**	**$987,500**
Implications for Ms. DEF		
FMV of shares	$2,000,000	$2,000,000
ACB of shares	$0	$900,000
Future sale (no capital gain)		
Disposition of shares	$2,000,000	$2,000,000
minus the ACB	$0	$900,000
Capital gain	$2,000,000	$1,100,000
minus CGD	$900,000	$900,000
Net capital gain	$1,100,000	$200,000
Net taxable capital gain (50% of net capital gain)	$550,000	$100,000
Tax (marginal rate of 50%)	$275,000	$50,000
Net amount received by Ms. DEF	**$1,725,000**	**$1,950,000**

19 With the loss carry-back and the application of stop loss rules.
20 With the loss carry-back and the application of stop loss rules.

CONCLUSION

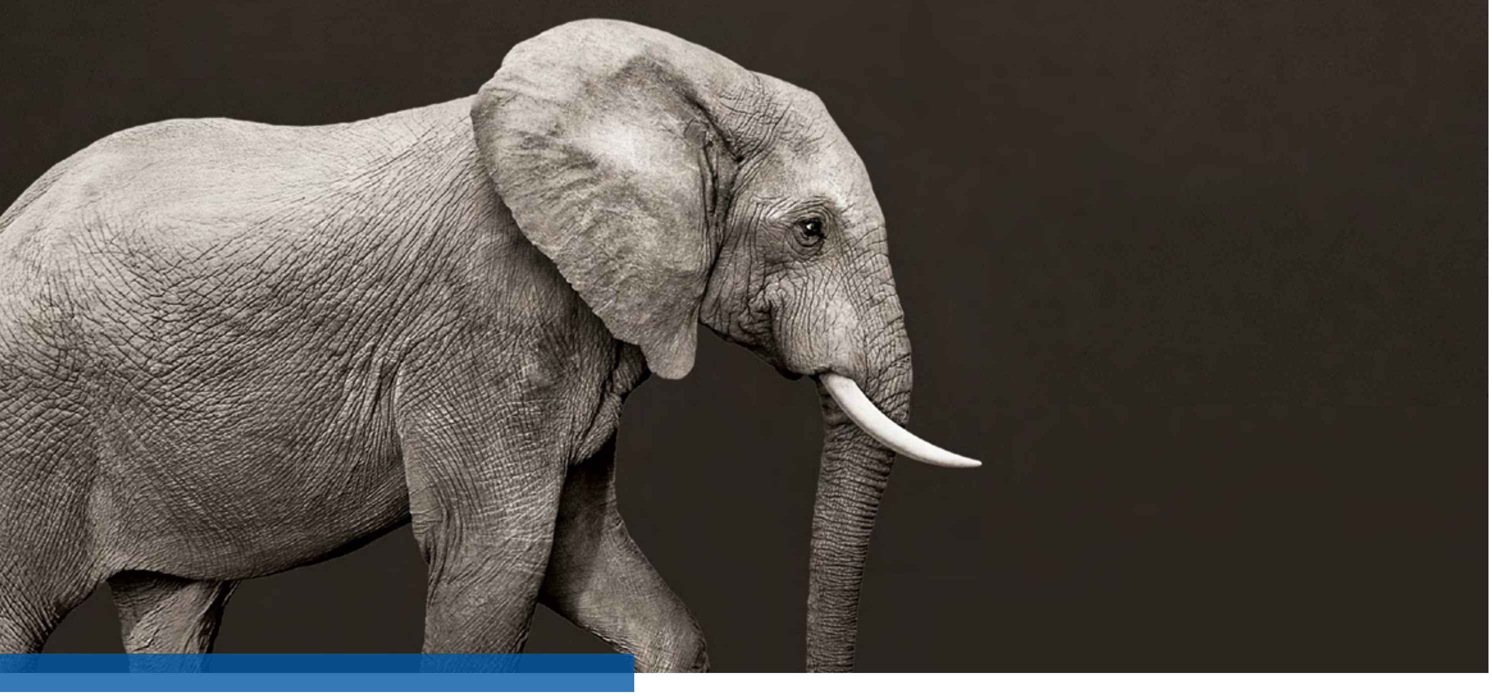
A shareholder agreement is an essential tool for building the relationship between shareholders to meet their needs. A detailed Agreement helps prevent, reduce, or resolve disputes and conflicts during the lifetime of the shareholders or in the event of death, and provides for terms and conditions relating to the transfer of shares depending on different circumstances.

In the event of the death of a shareholder, a life insurance policy is a valuable tool that helps planning for the financing of the transfer of the deceased's shares. In addition, an Agreement shall provide for flexible provisions for the transfer of shares in the event of the death of a shareholder. Indeed, on the one hand, the method of transfer of shares chosen will have a specific tax impact. On the other hand, the personal circumstances of shareholders may change, as may tax rates and laws. Thus, the Agreement should be drafted, reviewed and updated periodically, particularly when there is any change in the situation of shareholders or their wishes, as well as when a shareholder leaves or joins a corporation.

iA LARGE CASE **SOLUTIONS**

The iA Large Case Solutions program offers a support service for high net worth clients who need more complex financial strategies in the areas of taxation, sales concepts and product optimization of individual insurance and savings.

Our team of experts offers customized, simple, high-performance solutions that enable advisors to meet the specific needs of affluent clients, professionals and business owners.



F13-1206A ACC

INVESTED IN YOU.

ia.ca