INCOME TAX CONSIDERATIONS

IN SHAREHOLDERS' AGREEMENTS

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OVERVIEW

A shareholders' agreement is a contract entered into by some or all of the shareholders of a closely held corporation for the purposes of governing the relationship between and among the shareholders and the corporation. Normally a shareholders' agreement is negotiated at a time when all of the parties are getting along and are healthy. The primary purpose of such an agreement is to define the relationships among the parties and to deal with the possibility that these relationships may sour or that the parties may change due to disability or death. Shareholders' agreements normally set out provisions for decision-making such as the quorum for meetings of directors and shareholders, the majority required, how the corporation is to be financed, how distributions are to be made and most importantly, under what circumstances and how the shareholders must or may dispose of their shares to each other or to third parties.

Survivorship arrangements in these agreements must take into account the income tax implications arising as a result of the death of a shareholder and the manner in which the surviving shareholders will fund the buy-out of the deceased's shares. Income tax issues have a significant impact on how survivorship arrangements in shareholders' agreements should be structured. The first part of this paper deals with the structuring of survivorship arrangements, the choices available, the impact of income tax rates on those choices and certain stop-loss rules which effect those choices.

The second part of the paper reviews some selected issues that may arise when drafting a shareholders' agreement including the effect that certain types of rights or options may have on control of the corporation and on the income tax treatment of its issued shares. These issues should be understood since when drafting a shareholders' agreement, care must be taken to ensure that the terms do not cause unintended income tax consequences to the corporation or its shareholders. In order to provide some illustration of the matters discussed, some sample provisions of shareholder agreements are attached as a schedule.

BUY-SELL ARRANGEMENTS ON DEATH

In drafting buy-sell arrangements to take place in the event of death, the main issues are funding the obligation and structuring the arrangements in the most tax effective manner.

Funding the Purchase - Use of Life Insurance

It is possible for a corporation to fund the future obligation to purchase shares of a deceased shareholder out of corporate profits or by bank borrowings. While these financing methods may be necessary in the event of retirement of a shareholder, it is usually far easier to fund survivorship buy-sell arrangements by purchasing insurance on the lives of the shareholders. In addition, because an estate may have significant cash requirements to provide for the deceased's family or pay income taxes arising as a result of the death, life insurance is needed since it allows the surviving shareholders to pay all or a large portion of the purchase price immediately in order to provide the necessary funds to the estate.

Life Insurance premiums are usually not deductible because they are not considered to be incurred for the purposes of gaining or producing income. However, under the terms of paragraph 20(1)(e.2) of the Act, where the policy of life insurance has been pledged as collateral to a financial institution as security for amounts borrowed by the taxpayer for the purposes of gaining or producing income the premiums will be deductible by a taxpayer but only to the extent of the net cost of pure insurance in the year (what would normally be considered to be "term" insurance). Further, where the policy is pledged as collateral in this manner, the premiums will only be deductible to the extent that there are borrowings to be secured by the policies. If the taxpayer has a line of credit that fluctuates throughout the year, the premiums will only be deductible to the extent that the policies are security for actual indebtedness owing from time to time during the year. It would appear that if, for example, an insurance policy in the amount of $1,000,000 is pledged as collateral for a $1,000,000 line of credit, the premiums will only be deductible to the extent that the line was actually drawn

down during the year. Hence if only $200,000 is owing at any time during the year, only 20% of the premiums will be deductible.

Where neither the shareholders nor the corporation can deduct the insurance premiums and the corporation qualifies for the lower small business rate of tax, it will be less expensive in after-tax dollars for the corporation to hold the life insurance policies and pay the premiums, assuming the corporate tax rate is lower than the marginal rates of tax of each of the shareholders. Where an individual shareholder pays the non-deductible life insurance premiums, the shareholder will require greater funds from the corporation in the form of salary or dividends to cover the additional costs. Since such amounts are taxable, this increases the cash flow requirements of the operating company. Since shareholders usually wish to choose the structure that allows them to purchase life insurance at the least after tax cost, corporate owned insurance appears to be the most popular choice. However, where an operating company owns life insurance policies, there is a risk that the proceeds of insurance may become subject to the claims of creditors. Further, where the policy has been pledged to a financial institution as security for corporate debt, the institution may choose to retain the proceeds of insurance to pay down corporate debt rather than release the funds to allow for the funding of the buy-sell arrangements.

Where the shares of the operating company are held by holding corporations owned by the individuals, it is possible to have the holding corporations own the life insurance policies and pay the premiums out of tax-free intercorporate dividends (assuming no Part IV tax is payable). In such a case, the after-tax cost of the life insurance premiums will be the same as if the premiums had been paid by the operating company but the policies will be sheltered from the risks of the operating business.

In some cases, shareholders prefer that policies of insurance be held by the corporation in order to even out the cost of insurance. For example, shareholders of different ages or health records will be rated differently and where individuals hold the policies of insurance, some individuals may be required to pay higher

premiums than others. While it may seem unfair that a younger shareholder is required to pay higher premiums in respect of an older shareholder, it should also be recognized that the likelihood of receiving the proceeds of insurance is greater.

In most cases, particularly where the premiums cannot be deducted, clients prefer to have the policies held by the corporation primarily because the cost of the premiums is less noticeable when paid by the corporation and the administration of the insurance policies is less complicated.

Proceeds of life insurance policies are received on a tax-free basis. In the case of a corporation, the mortality gain in respect of the life insurance policy (which is the proceeds less the cost of the policy) is added to the capital dividend account of the corporation and can be paid to the shareholders as tax-free capital dividends. The cost of the policy including any amount representing the cash surrender value or investment proceeds of the policy, are also received tax free but in the case of a corporation, are added to retained earnings and can be extracted only on a taxable basis.

Structuring the Buy-Out

There are two basic types of buy-sell arrangements on death: the criss-cross arrangement and the corporate redemption arrangement. In a criss-cross arrangement, each shareholder owns a life insurance policy on the lives of the other shareholders and uses the proceeds of insurance to purchase the shares of the deceased or of the deceased's holding corporation. In the corporate repurchase arrangement, the operating corporation holds life insurance on the lives of all of the shareholders and uses the proceeds of insurance to redeem or purchase for cancellation the shares held by the deceased shareholder or such deceased's holding corporation.

Criss-Cross Buy-Sell

The criss-cross arrangement is best illustrated by a simple example. A and B each own 50% of the issued shares of Opco which have a nominal paid-up capital and nominal adjusted cost base. At the date of A's death, the fair market value of all

of the shares of Opco is $800,000 and the policy of insurance on the life of A will produce proceeds of $400,000. On the death of A, there is a deemed disposition of A's shares at their fair market value immediately before death resulting in a capital gain of $400,000. If the shares qualify as "qualified small business corporation shares" under Section 110.6 of the Act, some or all of that capital gain may be exempt from tax. If the capital gains exemption is not available, 50% of the capital gain or $200,000 will be received tax-free and the remaining $200,000 taxable capital gain will be subject to tax which, assuming the maximum tax rate applies, will be equal to approximately $92,800. A's estate will be deemed to have acquired the shares of Opco at an adjusted cost base of $400,000. If the estate were then to sell the shares to the surviving shareholder for $400,000 no additional gain or loss will arise. The surviving shareholder, B, will receive the $400,000 proceeds of life insurance tax-free and will use them to purchase the shares held by A's estate. After the sale is completed, B will own 100% of the issued shares of Opco and the adjusted cost base of all of the shares will now be $400,000. The effect of this arrangement is that A has realized the capital gain, if any, in the terminal year return and the proceeds of sale are received by the estate tax-free. The surviving shareholder has been able to acquire the shares of the deceased and increase the adjusted cost base of the shares by the amount paid for them. In return for bearing the cost of the insurance premiums, B was able to acquire the shares held by A's estate at no additional cost.

If the shares qualify as "small business corporation shares" the criss-cross arrangement allows the deceased to benefit from the $500,000 cumulative lifetime capital gains deduction. If the shareholders' agreement is carefully structured, it would be possible for a surviving spouse to also claim the benefit of the capital gains exemption if the fair market value of the shares is high enough. In our example, if the shares owned by A had been worth $1,000,000 on death and A's surviving spouse was entitled to receive those shares under the terms of A's will, the estate trustees could elect under subsection 70(6.2) of the Act to transfer a portion of the shares at fair market value in order to realize $500,000 of the capital gain in A's terminal year return and to benefit from the spousal rollover

under subsection 70(6) for the balance of the shares. On the sale by the surviving spouse, the remaining capital gain would be realized and the surviving spouse would be entitled to claim the capital gains exemption as well, to the extent it is otherwise available since under the terms of subsection 110.6(14) and 110.6(15) of the Act, the 24 month "hold period" does not apply.

In order to "double up" on the capital gains exemption in this manner however, the estate or the surviving spouse cannot, under the terms of the survivorship agreement, be obligated to sell the shares after the death. Where shares are subject to a mandatory buy-sell arrangement in the event of death and an individual directs by will that the shares are to be transferred to the surviving spouse or to a trust for the benefit of the spouse, the shares will not be considered to have vested indefeasibly in the spouse or spouse trust and the rollover in subsection 70(6) of the Act will not apply. This was the ruling of the Tax Court of Canada in Parkes Estate v. MNR (1986) 86 DTC 1214 and the Federal Court - Trial Division in Greenwood Estate v. The Queen (1990) 90 DTC 6690 and was adopted as its administrative practice by the Canada Revenue Agency ("CRA") as set out in Interpretation Bulletin IT- 449R. Where the agreement allows the estate or surviving spouse to "put" the shares to the other shareholders, while the other shareholders are given a "call" allowing them to require the estate or spouse to sell the deceased's shares, as a practical matter the same commercial objectives are achieved but the income tax consequences are different. Referring to our example, if, the shares were subject to such a put-call arrangement, A's shares that could benefit from the capital gains exemption would be subject to the election under subsection 70(6.2) of the Act and would be transferred to the spouse at an adjusted cost base of $500,000 and the remaining shares would be transferred to the spouse on a rollover basis at A's adjusted cost base pursuant to subsection 70(6); the spouse would claim the benefit of the capital gains exemption on the subsequent sale of the shares pursuant to the put-call option. This type of arrangement might also be beneficial where no life insurance or insufficient life insurance is available to fund the buy-sell arrangements due to the age or insurability of the shareholders.

Corporate Repurchase

Where a corporate repurchase arrangement is structured, the corporation is required to purchase the deceased's shares and the estate is deemed to receive a dividend to the extent that the purchase price exceeds the paid up capital of the shares. Referring to the same example, the insurance policies are held by Opco which paid the premiums and upon the death of A, Opco receives the $400,000 proceeds of insurance tax free. If we assume that the insurance policy had a nominal cost, the entire $400,000 is added to Opco's capital dividend account. In most cases however, there will have been a cost to the policy and it is only the amount in excess of this cost that is added to the capital dividend account. As in the example above, we have assumed that the capital gains exemption did not apply and the deceased, A, has realized the capital gain on death of $399,999 and the estate has acquired the shares at that adjusted cost base. If Opco then purchases the shares for cancellation, the estate will receive a deemed dividend equal to $399,999 (since we have assumed that the paid-up capital is nominal) and the corporation may elect to have this deemed dividend paid out of the capital dividend account of the corporation to the extent of the amount in that account. As a result the entire $400,000 capital dividend will be received by the estate tax-free.

The proceeds of disposition of the shares for capital gains purposes excludes any amount deemed to be a dividend. The estate has therefore received nil proceeds of disposition and has realized a capital loss of $399,999 since the adjusted cost base of the shares was $400,000.

In order to minimize the potential for double taxation that can arise on death, the Act permits, under subsection 164(6), a loss realized by an estate in its first taxation year, to be carried back to the terminal year of the deceased to offset capital gains realized by the deceased in the terminal year. In the example above, the estate realizes a capital loss because it has received a deemed dividend on the purchase for cancellation of the shares and is therefore deemed to have disposed of the shares at the nominal paid up capital amount of $1.00. This results in a capital loss of $399,999 which, subject to certain limitations imposed by the

dividend stop loss rules, could be carried back to reduce the capital gain realized by A in the terminal year.

The dividend stop loss rules will result in the denial of part of the capital loss that an individual or an estate would otherwise realize on a disposition of shares by a portion of the capital dividends received on the shares. These rules have a significant impact on drafting survivorship agreements. There are several exceptions to the rules as well as grandfathering provisions that can apply in certain circumstances.

The main exception to the rule is a de minimus test that applies where, at the time of payment of the capital dividend, the individual and persons who did not deal at arm's length with the individual did not own more than five percent of the issued shares of any class of the corporation **and** at the time of the disposition of the shares giving rise to the loss, the individual held them throughout the 365 day period immediately preceding. If **both** of these tests are met, the loss will not be denied.

Grandfathering provisions exempt from the application of these new stop loss rules any loss arising on a disposition of shares after April 26, 1995 in the following circumstances:

1. Where there was an agreement in writing entered into on or before that date **and** the disposition occurs after that date pursuant to the terms of that agreement, **or**;

2. The corporation was a beneficiary of a life insurance policy on the life of the individual or the spouse of the individual, **and**;

3. It is reasonable to conclude that on April 26, 1995 a main purpose of the life insurance policy was to fund the acquisition of the shares; **and**

4. The disposition is made by the individual or spouse of the individual whose life was insured or by his or her estate within its first taxation year.

The grandfathering rules are drafted broadly enough to include situations where a trust holds shares for a beneficiary who is the life insured or where a corporation is a member of a partnership which was the beneficiary of the life insurance policy. Finally if shares are exchanged or converted pursuant to Section 51, 85, 86 or 87, they are deemed to be the same shares that were held on April 26, 1995.

The dividend stop loss rules are also limited in circumstances where taxable dividends have also been paid. In such a case, capital dividends will only reduce the capital loss that may be carried back to the extent that the capital loss exceeds the total taxable dividends received by the estate. Secondly, in order to lessen the impact of these rules on integration, the rules provide that the capital loss carried back to the deceased's terminal year return will only be reduced to the extent that the loss exceeds one-half of the lesser of the capital gain on death and the estate's capital loss.

Referring to the example set out above, if the grandfathering applies either because the agreement was entered into before April 26, 1995 and the disposition occurs pursuant to the agreement or if the proceeds of life insurance payable out of the capital dividend account were received by the corporation under the terms of a policy existing prior to April 26, 1995, then if the purchase for cancellation takes place within one year of the date of death of A, subsection 164(6) of the Act allows the capital loss realized by the estate to be carried back to A's terminal year return to offset the capital gain of $400,000 realized immediately prior to death. As a result, neither A nor A's estate will pay any tax on the amount received from Opco. Since A's shares have been purchased for cancellation, B now owns 100% of the issued shares of Opco. While the fair market value of those shares has been increased to $800,000 there has been no corresponding increase in the adjusted cost base of the shares of Opco held by B. As a result, B's capital gain when the shares are eventually disposed of will be greater.

If these new grandfathering provisions do not apply, then the estate will receive the tax free capital dividend but most of the capital loss realized on the disposition of the shares will be denied. Referring again to the example,of the capital loss of

$400,000 realized by the estate, $200,000 can be carried back under subsection 164(6) to offset the $400,000 capital gain realized on A's death. This has assumed that no taxable dividends were paid to the estate on the redemption.

There may be circumstances where notwithstanding the amendments, the corporation would choose to pay a capital dividend to the estate even though half of the capital loss realized by it on the disposition would be denied. This would be the case if the deceased was entitled to claim the benefit of the capital gains exemption or had a high adjusted cost base to the shares or had net capital losses being carried forward. The result would be that the estate would receive the proceeds on a tax free basis and the capital gain realized by the deceased in his terminal year return would be reduced or eliminated either by the capital gains exemption or the net capital losses.

It is also possible to achieve the same result of avoiding the tax liability on death if the deceased leaves all of his or her shares to a surviving spouse or a trust exclusively for the benefit of the surviving spouse. In such case, the deceased does not realize a capital gain because the shares are transferred to the spouse on a "rollover" basis. The spouse or spouse trust would then receive the tax free capital dividend on the redemption or purchase for cancellation of the shares. The end result is that neither the deceased nor the spouse will realize a capital gain on the disposition of the shares.

Where grandfathering does not apply, then there may be some circumstances where a cross purchase of shares would be more beneficial; the estate would sell the shares to the surviving shareholder at the high adjusted cost base and not realize any gain or loss; the deceased would be treated the same way for tax purposes as if a capital dividend had been paid since the capital gain will be realized in the terminal year return; but the surviving shareholder would benefit from an increased adjusted cost base in the shares purchased by him and would be able to benefit from the capital dividend account of the corporation.

It may be beneficial to draft the shareholders' agreement flexibly in order to allow for either a purchase for cancellation or a cross purchase by the surviving

shareholder since at the time the agreement is drafted, it would be impossible to foresee which course of action would be most beneficial at the time the purchase is exercised. A flexibly drafted agreement will also allow the parties to account for the applicability of the capital gains exemption under Section 110.6 of the Act. It might be beneficial to allow for some of the shares to be purchased for cancellation and some to be purchased by the surviving shareholder from the estate of the deceased. On a death, the executors would determine the number of shares that the estate will sell to the surviving shareholders and the number of shares to be purchased for cancellation by the corporation and may also designate the portion of the deemed dividends to be designated as taxable dividends or capital dividends depending on the tax results that they wish to achieve. They would then be in a position to take into account the adjusted cost base of the shares, the capital gains exemption, net capital losses of the deceased and the income tax rates of the beneficiaries.

Another reason for drafting the shareholders' agreement as flexibly as possible is to ensure one does not trigger a superficial loss. Subsection 40(3.6) of the Act provides that where a taxpayer disposes of a share of the capital of a corporation to that corporation and immediately after the disposition the taxpayer and the corporation are affiliated, the taxpayer's loss on the disposition of the share is deemed to be nil and the loss that would have been realized is added to the adjusted cost base of the remaining shares of the corporation owned by the taxpayer.

For example, if A owned two classes of shares of a corporation, Class A which had voting control and common which had the value then the estate of A would control the corporation and would therefore be affiliated with it. This situation is very common where an estate freeze has previously taken place. The estate would have to first dispose of the Class A shares either to the intended beneficiary or to the corporation, otherwise the capital loss arising on the purchase for cancellation of the common shares would be deemed under subsection 40(3.6) to be nil.

Determining whether Grandfathering Applies

It is now necessary to determine in any particular situation, whether the new stop loss rules will apply or whether the survivorship arrangements can be grandfathered.

First, one must determine whether the shares were owned on April 26, 1995. It should be noted that if the shares were acquired after that date under any of sections 51,85,86 or 87 of the Income Tax Act, in exchange for shares which were owned on that date, the ownership test will be met.

If the ownership test is met, then either an agreement must have been in place or life insurance must have been acquired prior to April 26, 1995. If there was an agreement but no insurance, the agreement must remain intact and there can be no amendments to the agreement and there should be no subsequent exchanges of shares unless the agreement contemplates such exchanges. Further, it must be clear at the time of the sale (after the death) that the sale is taking place under the terms of the agreement so changes to terms at the time of sale will not be possible. Where an agreement that qualifies for this grandfathering was in existence on April 26, 1995, insurance can be obtained subsequently to fund the purchase and there is no deadline on when this insurance can be obtained.

If there was no shareholders' agreement on April 26, 1995 but the corporation was on that date the beneficiary of a life insurance policy, the arrangements will be grandfathered if a primary purpose of the policy was to redeem shares owned by the person or spouse of the person whose life was insured. If this is the case, grandfathering will apply regardless of when the shareholders' agreement is completed. In preparing the agreement now, one should ensure that it contemplates the possibility of share exchanges and/or the transfer of shares to a holding company. It is interesting to note that the insurance policy on which the grandfathering was originally based does not have to remain - it can be replaced, renewed, increased or converted without jeopardizing the grandfathering.

USE OF HOLDING CORPORATIONS

There are a number of benefits in structuring buy-sell arrangements when holding corporations are used to hold the shares of an operating corporation. As noted above, it is possible to have the holding corporations hold the life insurance policies on the lives of the principals of the other holding companies at the same after tax cost as if the policies were held by the operating corporation. The premiums can be paid out of dividends received for that purpose from the operating corporation which would be tax free assuming that Part IV tax would not be payable. This would insulate the proceeds of insurance from the risks of the business assuming that the policies are not pledged as collateral to a financial institution. If the proceeds of insurance are insufficient to fund the purchase of the shares held by the deceased's holding corporation, ordinary dividends which, subject to the applicability of Part IV tax, would be received as tax free intercorporate dividends, can be paid to the purchasing holding corporation to fund the balance of the purchase.

BUY-SELL ARRANGEMENTS ON DISABILITY

It is not uncommon to see buy-sell provisions that take effect where an individual who has been active in an operating business becomes disabled for an extended period of time and it does not appear that the individual will return to full-time activity. In most small businesses where the shareholders or principals are active, it becomes a burden on the other shareholders to continue to support the one who has become ill and a buy-sell arrangement allows the remaining shareholders to disengage from the problem. While income replacement insurance exists, it is unusual to see situations where a policy of insurance is available to fund the purchase of the disabled party's shares. Even if such insurance is available, the proceeds of insurance do not fall into the capital dividend account of the corporation and can therefore not be transferred to shareholders on a tax free basis.

Since insurance is rarely purchased, disability arrangements in a shareholders' agreement must deal with the likelihood that payment of the purchase price will be over an extended period of time. Since the vendor will no longer be active in the business, there ought to be some consideration given to securing the unpaid balance of the purchase price.

If insurance to fund the buy-sell arrangement is acquired and the shareholders are individuals, it would be preferable for the sale to be a criss-cross arrangement rather than a corporate repurchase. Unlike a death, there is no deemed disposition upon becoming disabled and there is therefore no need to create a capital loss to offset the gain. Any disposition of shares will trigger a capital gain which may be eligible for the capital gains exemption if the shares are qualified under subsection 110.6 of the Act. If a sale takes place and a portion of the purchase price remains unpaid, the vendor may claim a reserve in respect of the unpaid amount for the maximum five year reserve period.

If a corporate repurchase is used, there is no reserve available for the unpaid portion of the proceeds of a purchase for cancellation or redemption of shares. If the parties wish to structure the purchase in this manner, consideration should be given to reorganizing the share capital of the corporation to create a class of frozen, redeemable preferred shares which can be redeemed or purchased for cancellation over time thereby triggering the tax liability in respect of the shares only as the proceeds of redemption are received.

CONTROL OF THE CORPORATION

Where one shareholder of a corporation or a related group of shareholders owns or controls more than 50% of the voting shares of a corporation, that shareholder or group will control the corporation. Any other corporation controlled by the same person or group will be related and possibly associated with the first corporation (See Sections 251 and 256 of the Income Tax Act (the "Act")). The impact of two or more corporations being related or associated is beyond the

scope of this paper. However, where there are several shareholders of a corporation each of whom owns 50% or less of the shares of the corporation, none of the shareholders would control the corporation unless control was conferred by the terms of the shareholders' agreement.

It is not uncommon for agreements among shareholders to provide for the exercise of voting rights by one or more shareholders under certain circumstances or to allow one shareholder the right to buy the shares of another. Most often the parties agree to these rights or options in order to allow one shareholder or a group to effectively control the corporation upon the happening of certain events. For income tax purposes however, these rights may sometimes be treated as if they had been exercised, for the purposes of determining who controls the corporation at any time. Paragraph 251(5)(b) of the Act provides:

> "where at any time a person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently
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> (i) to, or to acquire, shares of the capital stock of a corporation or to control the voting rights of such shares shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to have the same position in relation to control of the corporation as if that person owned the shares at that time, or
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> (ii) to cause a corporation to redeem, acquire or cancel any shares of its capital stock owned by other shareholders of the corporation shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an

individual be deemed to have the same position in relation to the control of the corporation as if the shares were so redeemed, acquired or cancelled by the corporation at that time;

(iii) to, or to acquire or control, voting rights in respect of shares of the capital stock of a corporation, the person shall, except where the right is not exercisable at that time because its exercise is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to have the same position in relation to the control of the corporation as if the person could exercise the voting rights at that time; or

(iv) to cause the reduction of voting rights in respect of shares, owned by other shareholders, of the capital stock of a corporation, the person shall, except where the right is not exercisable at that time because its exercise is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to have the same position in relation to the control of the corporation as if the voting rights were so reduced at that time;"

If a right or option in a shareholders' agreement causes paragraph 251(5)(b) of the Act to apply, the shareholders will be placed in the same position as if the option or right had been exercised for the purposes of the definition of a Canadian controlled private corporation in paragraph 125(7)(b) of the Act and for the purposes of determining whether parties are at arm's length in subsection 251(2) of the Act. Such rights may therefore have an impact on whether the corporation is entitled to the small business deduction, how stock options will be treated, how investment income will be taxed as well as numerous other issues that may arise.

Subsection 256(1.4) of the Act is similar to paragraph 251(5)(b) and if it applies, the parties will be placed in the same position as if the option or right had been exercised for the purposes of determining whether the corporation and any other corporation are associated for the purposes of the Act. If two or more corporations are associated, there are a significant number of income tax consequences including, inter alia, a requirement to share the small business deduction as well as certain deductions in computing income under certain circumstances such as interest expense (Subsection 18(2.3)), research allowances (Subsection 37.1(2)) and there will also be an impact on the ability to claim certain tax credits. Section 256 of the Act provides the rules for determining whether corporations are associated and includes the following subsection which applies for the purposes of those rules:

> *"(1.4)* ***Options and Rights****. - For the purpose of determining whether a corporation is associated with another corporation with which it is not otherwise associated, where a person or any partnership in which the person has an interest has a right at any time under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently,*
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> > *(a) to, or to acquire, shares of the capital stock of a corporation or to control the voting rights or shares of the capital stock of the corporation, the person or partnership shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to own the*

> *shares at that time, and the shares shall be deemed to be issued and outstanding at that time; or*
>
> *(b) to cause a corporation to redeem, acquire or cancel any shares of its capital stock owned by other shareholders of a corporation, the person or partnership shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed at that time to have the same position in relation to control of the corporation and ownership of shares of its capital stock as if the shares were redeemed, acquired or cancelled by the corporation."*

You will note that paragraph 251(5)(b) is broader than subsection 256(1.4). Clause 251(5)(b)(iii) treats a person as being able to exercise voting rights if they have in the future a right to acquire those voting rights except in the exempted circumstances and clause 251(5)(b)(iv) treats voting rights as having been reduced if a person has a right to cause the reduction of another shareholder's voting rights except in the exempted circumstances. This prevents shareholders from circumventing paragraph 251(5)(b) by inserting provisions in their agreement allowing one shareholder to cause another shareholder's voting rights to be eliminated rather than being acquired by that shareholder.

The wording of both paragraph 251(5)(b) and subsection 256(1.4) excludes their application in the case of rights to acquire shares arising upon the death,

bankruptcy or permanent disability of a shareholder. Neither provision should therefore be of concern if the rights to acquire the shares only arise upon the happening of one of the excluded events. If, however, one shareholder has a right to exercise the voting rights in respect of another shareholder's shares upon the happening of a default that is not one of the excluded events such as failure to enter into a guarantee or termination of employment, then even if such right is only exercisable upon the happening of a future event, the shareholder having the right will be treated as owning those shares at any time.

With respect to rights to acquire shares, Interpretation Bulletin IT-419 dated July 10, 1978 and Interpretation Bulletin IT-64R3 dated March 9, 1992 both set out the CRA's position regarding the application of paragraph 251(5)(b) and subsection 256(1.4) of the Act. In these Interpretation Bulletins, the CRA states that it is not its practice to apply these provisions unless one or more of the parties clearly has either a right or an obligation to buy or sell their shares.

An example of the type of acquisition option or right to which paragraph 251(5)(b) would apply is a "put" option in which one shareholder is granted the right to require that its shares be purchased by another shareholder at some point in time. Since the other shareholder has a contingent obligation to purchase the shares, paragraph 251(5)(b) and subsection 256(1.4) would apply to treat that shareholder as if the shares were owned by that shareholder even though the obligation to purchase the shares is not within that shareholder's control. Another example would be a "call" option which allows one shareholder to force another shareholder to sell its shares at some point in time. Again, since there is a right to buy and an obligation to sell contingent upon the exercise of the option, paragraph 251(5)(b) and subsection 256(1.4) of the Act would apply.

Where a shareholder is given a right of first refusal allowing that shareholder to choose to purchase shares in the event that another shareholder wishes to sell to a third party, it is CRA's position that this does not confer a right to acquire a share but grants an option to acquire a right in certain future circumstances to acquire a share and paragraph 251(5)(b) and subsection 256(1.4) of the Act do not apply.

It is also CRA's position that paragraph 251(5)(b) and subsection 256(1.4) of the Act will also not apply to a shotgun buy/sell arrangement, whereby each shareholder has the right to make an offer to the other shareholders to sell its shares or buy their shares at the price fixed by such shareholder in the offer. In CRA's view, none of the shareholders clearly has either a right or an obligation to buy or sell its shares until the shotgun offer is made and accepted by one or more of the shareholders.

While the above-noted Interpretation Bulletins do not address "piggy back" or "drag along" rights, they may also not be caught by paragraph 251(5)(b) or subsection 256(1.4) of the Act so long as they are drafted to ensure that the rights are exercisable by any shareholder in the event of a third party offer and not at the option of any particular shareholder. A "piggy back" right allows a minority shareholder to have its shares purchased under the same terms and conditions as another shareholder if such other shareholder receives a third party offer. A "drag along" right requires that a shareholder sell its shares under the same terms and conditions as other shareholders in the event that such other shareholders sell their shares to third parties. If such rights are granted to all shareholders then they become similar to rights of first refusal in that no party has a clear obligation to buy or sell until the right is exercised. If, however, a particular shareholder is granted these rights in respect of other shareholders then there are contingent obligations on the part of one shareholder to buy and another shareholder to sell and paragraph 251(5)(b) and subsection 256(1.4) would likely apply.

One must also review carefully the default provisions under the terms of a shareholders' agreement or the bylaws of a corporation that allow one shareholder to convert non-voting shares into voting shares or allow one shareholder to buy out another. For example, there are circumstances where a class of preferred or special shares are non-voting but become entitled to vote in connection with a reorganization of the corporation or a resolution to wind it up. Similar rights of non-voting shares to become voting shares may exist where there has been a failure to pay dividends or where the corporation intends to sell all or substantially all of its assets or to do some other fundamental change in the

business or assets of the corporation. Where such a contingent right to vote exists, the preferred shares will be considered to be voting shares for all purposes and paragraph 251(5)(b) and subsection 256(1.4) will apply.

Where the parties have knowingly included terms in the shareholders' agreement which cause the corporation to be associated with another, they may wish to consider a variation of the sample warranty clause in item 1 of the schedule attached so that the parties agree in advance on the allocation of deductions and tax credits where such allocations may be made among associated corporations.

SHORT TERM PREFERRED SHARES AND TAXABLE PREFERRED SHARES

There are circumstances where a term of a shareholders' agreement which ordinary business people may view as commercially reasonable, will cause unforseen and possibly adverse income tax consequences. The preferred share rules contained in the Act are intended to apply where shares are issued as a substitute for debt. Unfortunately, there are circumstances where these types of shares will be created as part of an estate freeze and will give rise to unintended adverse income tax consequences when dividends in such shares are paid or deemed to be paid. The definition of a "short term preferred share" is found in subsection 248(1) of the Act. In essence, a short term preferred share will exist if:

> *2. Under the terms of any agreement relating to the share the corporation or a person who does not deal at arm's length with the corporation, may be required to acquire the share at any time within five years from the date of its issue, the entering into of the agreement or a significant amendment to the share terms or the agreement;*

> *3. The share is convertible or exchangeable at any time within five years from the date of its issue into short term preferred shares or debt securities;*
>
> *4. If there is a "guarantee agreement" in respect of the shares, that is, an undertaking of any person other than the corporation that has the effect of limiting any loss that might be incurred in respect of the share during the five year period.*

The share will not be considered to be a short term preferred share where the requirement to acquire the share only arises in the event of the death of the shareholder, or a shareholder of the shareholder. An exemption will also exist where under the terms of the share or the agreement, the purchase price for the share within the five year period would not exceed its fair market value at the time of the acquisition of the share determined without reference to the agreement or if the price is an amount determined by appraisal to be an amount that does not exceed the fair market value of the share at the time of the acquisition, determined without reference to the agreement. If the acquisition of the share is to occur within sixty days of the time that the agreement was entered into, the acquisition price may be based on the fair market value of the share at the time the agreement was entered into rather than at the time of acquisition.

It is important to note that the definition of short term preferred share applies even if the factors set out in the definition are uncertain. If, for example, a shareholders' agreement provides for a call option allowing a majority shareholder to require that a minority shareholder sell his shares at a fixed price or at a price determined by formula which could potentially exceed the fair market value of the share at the time the call option is exercised, the shares held by the minority shareholder will be considered to be short term preferred shares from the moment of their issuance.

Where shares are found to be short term preferred shares, a corporation paying dividends on the shares will be subject to a special 66 2/3% tax under Part VI.1 of

the Act, unless the shareholder has a "substantial interest" in the payor corporation or the dividend does not exceed the relevant portion of a dividend allowance of $500,000. The Part VI.1 tax will also be payable by the payor corporation on any deemed dividend arising on the purchase for cancellation or redemption of the short term preferred shares unless either of the two exemptions described above applies or the exemption in subsection 191(4) of the Act, described below, is available.

Where a shareholder has a substantial interest in a taxable Canadian corporation, the dividends paid to him on the short term preferred shares will not be subject to the Part VI.1 tax. Subsection 191(2) of the Act defines a substantial interest as existing if:

1. The shareholder is related to the corporation at that time otherwise than by reason of a right described in paragraph 251(5)(b); or

2. The shareholder or persons with whom the shareholder is related (otherwise than by reason of paragraph 251(5)(b)) owns:

   (a) shares of the corporation that give such shareholder 25% or more of the votes that could be cast under all circumstances at an annual meeting of shareholders of the corporation;

   (b) shares of the corporation having a fair market value of 25% or more of the fair market value of all of the issued shares of the corporation; and

   (c) either:

      (i) participating shares, other than short term preferred shares (or other taxable preferred shares), having a fair market value of 25% or more of the fair market value of all of such participating shares of the corporation; or

(ii) for each class of issued shares, shares of that class representing 25% or more of the fair market value of all shares of that class.

Where taxable Canadian corporations are associated, they are entitled to share the dividend allowance of up to $500,000 per annum. To the extent that any dividend or deemed dividend is within the $500,000 limit, or the payor corporation's share of that limit if it is associated with other corporations, the tax under Part VI.1 of the Act will be reduced.

Where the payor corporation is required to pay the Part VI.1 tax, it is entitled to deduct 9/4 of the tax paid in computing its taxable income for the purposes of the Act. If the payor corporation has sufficient taxable income, the Part VI.1 tax will be fully offset by the deduction if the combined rate of federal and provincial tax payable by the corporation is 44.44% or more. If the tax rate for the payor corporation is lower due to the existence of the manufacturing and processing deduction, the small business deduction or the provincial tax rate of the jurisdiction in which the corporation carries on business, then the Part VI.1 tax will not be fully absorbed. In addition, where the payor corporation earns investment income, this deduction of 9/4 of the Part VI.1 tax will reduce the amount credited to the corporation's refundable dividend tax on hand account.

A taxable preferred share is defined in subsection 248(1) to include a short term preferred share as well as any other share:

1. where by reason of its terms or any agreement relating to the share it is reasonable to conclude that the dividend entitlement determined by formula or otherwise is fixed, limited to a maximum amount or required to be a minimum amount,

2. where by reason of its terms or any agreement relating to the share it may reasonably be considered that the liquidation entitlement, or the amount that the shareholder is entitled to receive on the redemption, acquisition or

cancellation of the share is fixed or limited to a maximum or minimum amount;

3. that is convertible or exchangeable at any time into a taxable preferred share;

4. where there is a "guarantee agreement" in respect of a share.

In the case of taxable preferred shares, there is no exemption where the entitlement can only arise more than five years after the issuance of the share or the making of the agreement. If the liquidation entitlement is fixed but the right to redeem, acquire or cancel the share arises only in the event of the death of the shareholder or by reason of a right to convert or exchange the share, the share will not be deemed to be a taxable preferred share.

If, for example, one were to confer a call option on a majority shareholder giving him the right to call for the purchase of the shares held by a minority shareholder and the price payable is a fixed amount or an amount determined by formula the share would be a taxable preferred share even if the call option was only exercisable more than five years after the issuance of the share.

Where a share is a taxable preferred share other than a short term preferred share, the tax consequences are similar for those relating to short term preferred shares except that the tax rate under Part VI.1 is 25% (or in some cases 40%) rather that the 66 2/3%. The exemptions for a substantial interest and the $500,000 dividend allowance as well as the exemption under subsection 191(4) are also applicable to taxable preferred shares.

Under subsection 191(4) there is an exemption from the Part VI.1 tax for deemed dividends where a share is issued or there is an agreement in respect of a share and its terms require the payment of a "specified amount" in respect of the share upon a redemption, acquisition or cancellation that does not exceed the fair market value of the consideration for which the share was issued or does not exceed the fair market value of the share immediately before the time that the agreement was entered into. CRA takes the position that "a specified amount"

must be a fixed dollar amount rather than an amount determined by formula. Accordingly, if shares are redeemable for the fixed amount of $1.00 each then any deemed dividend arising on their redemption will be an excluded and excepted dividend provided this was the fair market value of the consideration for which the shares were first issued.

Many lawyers who deal primarily with small business corporations in their practices assume that short term preferred shares and taxable preferred shares are only relevant to public corporations or large private corporations. There are many circumstances where unexpected income tax consequences may arise because a short term preferred or taxable preferred share was created in the course of an estate freeze and the exemptions from Part VI.1 tax do not apply.

SCHEDULE 1
SAMPLE SHAREHOLDER AGREEMENT PROVISIONS

I. Warranty re: association

Each shareholder warrants that, [to the best of his knowledge and belief after due enquiry] the Corporation is not associated (as that term is used in the Income Tax Act (Canada)) with any other corporation and hereby covenants that if the Corporation becomes so associated, all appropriate forms and elections will be filed to ensure that, to the maximum extent possible, the Corporation has allocated to it, in each taxation year, the amounts necessary with respect to its business limit to enable the Corporation to take the maximum small business deduction available in such taxation year, as those terms are used in the Income Tax Act (Canada).

II. Criss-Cross Buy-out on Death

(individual shareholders)

SURVIVORSHIP ARRANGEMENTS

1. Upon the death of any Shareholder (hereinafter in this Article called the "Deceased"), the personal representatives of the Deceased (hereinafter in this Article called the "Vendor") shall sell all of the shares of the Corporation beneficially owned by the Vendor (hereinafter in this Article called the "Purchased Shares") to the surviving Shareholder(s) (hereinafter in this Article called the "Purchaser(s)") and the Purchaser(s) shall purchase from the Vendor the Purchased Shares, upon and subject to the terms and conditions hereinafter set forth.

2. The purchase price for the Purchased Shares shall be determined in accordance with the provisions of Article *[valuation provision] of this agreement.

3. The aggregate purchase price for the Purchased Shares shall be paid as follows:

   (a) the greater of:

      (i) an amount (not to exceed the purchase price) equal to the proceeds of all insurance policies on the life of the Deceased, if any, which may be

payable to the Purchaser in accordance with the provisions of Article *[**insurance policy provision**] hereof; and

(ii) *percent of the purchase price,

shall be paid at the Time of Closing; and

(b) the balance shall be paid in equal consecutive monthly instalments over a period of * years from the Date of Closing (as defined in this Article), 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 or judgment and as well after as before maturity, which is equal to the Prime Bank Rate plus * percentage points, with interest on overdue interest at the same rate. Such interest shall be payable at the same time 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.

4. If there is more than one Purchaser, each Purchaser shall purchase that number of Purchased Shares which is proportional to his respective beneficial ownership of fully-participating shares of the Corporation on the Date of Closing.

5. The closing of the transaction of purchase and sale contemplated in this Article shall take place at the Place of Closing at the Time of Closing on the Date of Closing. For the purposes of this Article the "Date of Closing" is the date which shall be the latest of:

(a) the date which is 30 days after the relevant death;

(b) the date which is seven days following receipt of all necessary governmental releases or other approvals required to be obtained in order to effect a valid transfer of the Purchased Shares (and the parties hereto covenant and agree to use their best efforts to obtain such releases);

(c) the date which is 30 days after the purchase price for the Purchased Shares is finally determined in accordance with the provisions of Article *[valuation provision] hereof; and

(d) the date upon which the Purchaser receives the proceeds of insurance referred to in Article *[**insurance provision**] hereof and payable on the life of the Deceased or, if applicable, the date on which it is finally determined that no proceeds of insurance are payable.

6. Notwithstanding anything hereinbefore contained, if all of the Shareholders die within 30 days of one another, the provisions of this Article * (save and except this Section) shall not apply.

(where shareholders are holding companies)

SURVIVORSHIP ARRANGEMENTS

1. Upon the death of a Principal (hereinafter in this Article called the "Deceased"), the Shareholder of which the Deceased was the Principal (hereinafter in this Article called the "Vendor") shall sell all of the shares of the Corporation beneficially owned by the Vendor (hereinafter in this Article called the "Purchased Shares") to the other Shareholder(s) (hereinafter in this Article called the "Purchaser(s)") and the Purchaser(s) shall purchase from the Vendor the Purchased Shares, upon and subject to the terms and conditions hereinafter set forth.

2. The purchase price for the Purchased Shares shall be determined in accordance with the provisions of Article * **[valuation provision]** of this agreement.

3. The aggregate purchase price for the Purchased Shares shall be paid as follows:

(a) * percent thereof shall be paid at the Time of Closing; and

(b) the balance shall be paid in equal consecutive monthly instalments over a period of * years from the Date of Closing (as defined in this Article), 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 or judgment and as well after as before maturity, which is equal to the Prime Bank Rate plus * percentage points, with interest on overdue interest at the same rate. Such interest shall be payable at the same time 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.

4. If there is more than one Purchaser, each Purchaser shall purchase that number of Purchased Shares which is proportional to his respective beneficial ownership of fully-participating shares of the Corporation on the Date of Closing.

5. The closing of the transaction of purchase and sale contemplated in this Article shall take place at the Place of Closing at the Time of Closing on the Date of Closing. For the purposes of this Article, the "Date of Closing" is the date which shall be the latest of:

(a) the date which is 30 days after the relevant death;

(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 (and the parties hereto covenant and agree to use their best efforts to obtain such releases); and

(c) the date which is 30 days after the purchase price for the Purchased Shares is finally determined in accordance with the provisions of Article *[**valuation provision**] hereof.

6. Notwithstanding anything hereinbefore contained, if all of the Principals die within 30 days of one another, the provisions of this Article * (save and except this Section) shall not apply.

III. Purchase for Cancellation

(individual shareholders)

SURVIVORSHIP ARRANGEMENTS

1. Upon the death of any Shareholder (hereinafter in this Article called the "Deceased"), the personal representatives of the Deceased (hereinafter in this Article called the "Vendor") shall sell all of the shares of the Corporation beneficially owned by the Vendor (hereinafter in this Article called 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 forth.

2. The purchase price for the Purchased Shares shall be determined in accordance with the provisions of Article *[**valuation provision]** of this Agreement.

3. The aggregate purchase price for the Purchased Shares shall be paid as follows:

   (a) the greater of:

      (i) an amount, not to exceed the purchase price, equal to the proceeds of all insurance policies on the life of the Deceased, if any, which may be payable to the Corporation in accordance with the provisions of Article *[insurance] hereof; and

      (ii) * % of the purchase price,

   shall be paid at the Time of Closing; and

   (b) the balance shall be paid in equal consecutive monthly instalments over a period of * years from the Date of Closing (as defined in this Article), 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 or judgment and as well after as before maturity, which is equal to the Prime Bank Rate plus * percentage points, with interest on overdue interest at the same rate. Such interest shall be payable at the same time 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.

4. The closing of the transaction of purchase and sale contemplated in this Article shall take place at the Place of Closing at the Time of Closing on the Date of Closing. For the purposes of this Article, the "Date of Closing" is the date which shall be the latest of:

(a) the date which is 30 days after the relevant death;

(b) the date which is seven days following receipt of all necessary governmental releases or other approvals required to be obtained in order to effect a valid transfer of the Purchased Shares (and the parties hereto covenant and agree to use their best efforts to obtain such releases);

(c) the date which is 30 days after the purchase price for the Purchased Shares is finally determined in accordance with the provisions of Article ***[valuation]** hereof; and

(d) the date upon which the Corporation receives the proceeds of insurance on the life of the Deceased referred to in Article * hereof or, if applicable, the date on which it is finally determined that no proceeds of insurance are payable.

5. Immediately upon receipt of the insurance proceeds payable on the life of the Deceased, the Corporation shall take all corporate actions and effect all prescribed elections and filings as may be required under the Income Tax Act (Canada) (in this Article, the "Act") so that the Purchase Price shall, to the extent that the capital dividend account (as defined in the Act) of the Corporation has been increased as a result of the Corporation's receipt of the proceeds of life insurance policies payable upon the death of the Deceased, be considered to have been paid out of the Corporation's capital dividend account.

...

(corporate shareholders)

SURVIVORSHIP ARRANGEMENTS

1. Upon the death of a Principal (hereinafter in this Article called the "Deceased"), the Shareholder of which the Deceased was the Principal (hereinafter in this Article called the "Vendor"), shall sell all the shares of the Corporation beneficially owned by the Vendor (hereinafter in this Article called 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 forth.

(balance of the article can be the same as Article 3, above)

IV. PUT AND CALL ARRANGEMENTS

ARTICLE i - PUT ARRANGEMENTS

1. At any time after the death of or , the personal representative of the Deceased (hereinafter in this Article sometimes called the "Vendor") shall be entitled to send a notice in writing to the Corporation and the surviving shareholder (hereinafter in this Article sometimes collectively called the "Purchasers") requiring each of the Purchasers to purchase such number of the shares of the Corporation beneficially owned by the Vendor as the Vendor shall designate (hereinafter in this Article sometimes called the "Purchased Shares") and the Purchasers shall purchase from the Vendor the Purchased Shares upon and subject to the terms and conditions hereinafter set forth.

2. The purchase price for the Purchased Shares shall be an amount equal to the [Fair Market Value of the Purchased Shares determined in accordance with Article * hereof] proceeds of the life insurance described in Article * hereof.

3. The parties hereto agree to exercise their vote and influence to cause the Corporation to:

   (a) use the proceeds of the Policy to pay the purchase price; and

   (b) to take all corporate actions and effect all prescribed elections and filings as may be necessary or desirable under the Income Tax Act (Canada) to treat that portion of the deemed dividend arising upon the repurchase of the purchased shares equal to the increase in the capital dividend account of the Corporation arising out of its receipt of the life insurance proceeds from the Policy as a capital dividend.

4. The closing of the transaction of purchase and sale herein contemplated shall take place at the Place of Closing at the Time of Closing on the date (in this Article, the "Date of Closing") which shall be the later of:

   (a) the date which is sixty (60) days after the Deceased's death;

   (b) the date which is ten (10) days after the date upon which the Corporation receives the proceeds of insurance payable on the life of the Deceased;

ARTICLE ii - **CALL ARRANGEMENTS**

1. At any time after the death of or , the Corporation and the surviving shareholder (hereinafter in this Article sometimes collectively called the "Purchasers") shall be entitled to send a notice in writing to the personal representative of the Deceased (hereinafter in this Article sometimes called the "Vendor") requiring the Vendor to sell such number of the shares of the Corporation beneficially owned by the Vendor to the Purchasers as the Purchasers shall designate (hereinafter in this Article sometimes called the "Purchased Shares") and the Purchasers shall purchase from the Vendor the Purchased Shares upon and subject to the terms and conditions hereinafter set forth.

2. The purchase price for the Purchased Shares shall be [the Fair Market Value of the Purchased Shares determined in accordance with Article * hereof] an amount equal to the proceeds of the life insurance described in Article * hereof.

3. The parties hereto agree to exercise their vote and influence to cause the Corporation to:

   (a) use the proceeds of the Policy to pay the purchase price; and

   (b) to take all corporate actions and effect all prescribed elections and filings as may be necessary or desirable under the Income Tax Act (Canada) to treat that portion of the deemed dividend arising upon the repurchase of the Purchased Shares equal to the increase in the capital dividend account of the Corporation arising out of its receipt of the life insurance proceeds from the Policy as a capital dividend.

4. The closing of the transaction of purchase and sale herein contemplated shall take place at the Place of Closing at the Time of Closing on the date (in this Article, the "Date of Closing") which shall be the later of:

   (a) the date which is sixty (60) days after the Deceased's death;

   (b) the date which is ten (10) days after the date upon which the Corporation receives the proceeds of insurance payable on the life of the Deceased;

V. DISABILITY

(individual shareholders)

DISABILITY

1. If a Shareholder (hereinafter called a "Disabled Party") through bona fide illness, physical or mental, shall be unable to devote the time and attention to the affairs of the Corporation required of such Shareholder, the Disabled Party shall, as long as such disability continues, be entitled to receive from the Corporation the then full compensation payable to him by the Corporation for a period of * months from the commencement of such disability. If such disability shall continue for more than * months, then, thereafter, as long as such disability continues, no further compensation shall be payable by the Corporation to the Disabled Party. Notwithstanding the foregoing, the amount payable to the Disabled Party shall be reduced by the amount of any payments received by the Disabled Party under any policy of disability insurance

2. If such disability shall continue for * months from the commencement of such disability, the Shareholder who is the Disabled Party (hereinafter in this Article called the "Vendor") shall sell all of the shares of the Corporation beneficially owned by the Vendor (hereinafter in this Article called the "Purchased Shares") to the other Shareholder(s) (hereinafter in this Article called the "Purchaser(s)") and the Purchaser(s) shall purchase from the Vendor the Purchased Shares, upon and subject to the terms and conditions hereinafter set forth.

3. The purchase price for the Purchased Shares shall be determined in accordance with the provisions of Article ***[valuation]** hereof.

4. The purchase price for the Purchased Shares shall be paid in full at the Time of Closing.

   or

5. The purchase price for the Purchased Shares shall be paid as follows:

   (a) * shall be paid at the Time of Closing; and

(b) the balance shall be paid in equal consecutive monthly instalments over a period of * years from the Date of Closing (as defined in this Article), 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 or judgment, and as well after as before maturity, which is equal to the Prime Bank Rate plus * 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 aforesaid 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.

6. If there is more than one Purchaser, each Purchaser shall purchase that number of Purchased Shares which is proportionate to his respective beneficial ownership of fully-participating shares of the Corporation on the Date of Closing.

7.

(a) For the purposes of this Article, a period of disability for the Disabled Party shall be deemed to commence on the first working day that a Disabled Party does not attend to the affairs of the Corporation [on a full time basis], statutory holidays and vacations excepted.

(b) In the event that a Disabled Party shall return to attending to the affairs of the Corporation [on a full time basis] after having experienced a period of incapacity, and so long as he shall be attending to the affairs of the Corporation [on a full time basis] he shall be entitled to his full salary for such period during which he attended to the affairs of the Corporation [on a full time basis], notwithstanding that at some later date he shall again become incapacitated.

(c) In calculating the period of disability for the purposes of this Article, unless and until such Disabled Party shall have returned to attending to the affairs of the

Corporation on [a full time basis] for thirty (30) consecutive normal working days, the said period of disability shall be deemed to have continued without interruption whatsoever.

(Closing provisions)

8. Each Shareholder shall obtain and maintain in full force and effect disability insurance insuring himself in respect of an amount not less than * per month. The expenses incurred in obtaining such policy of insurance shall be borne by the Shareholder and all such policies of insurance shall provide that the benefits thereunder shall commence no later than * months following the commencement of the disability of the Shareholder insured thereunder.

(corporate shareholders)

DISABILITY

1. If a Principal (hereinafter called a "Disabled Party") through bona fide illness, physical or mental, shall be unable to devote the time and attention to the affairs of the Corporation required of such individual, the Disabled Party shall, as long as such disability continues, be entitled to receive from the Corporation the then full compensation payable to him by the Corporation for a period of * months from the commencement of such disability. If such disability shall continue for more than * months, then, thereafter, as long as such disability continues, no further compensation shall be payable by the Corporation to the Disabled Party. Notwithstanding the foregoing, the amount payable to the Disabled Party shall be reduced by the amount of any payments received by the Disabled Party under any policy of disability insurance.

2. If such disability shall continue for * months from the commencement of such disability, the Shareholder of which the Disabled Party is the Principal (hereinafter in this Article called the "Vendor") shall sell all of the shares of the Corporation beneficially owned by the Vendor (hereinafter in this Article called the "Purchased Shares") to the other Shareholder(s) (hereinafter in this Article called the "Purchaser(s)") and the Purchaser(s) shall purchase from the Vendor the Purchased Shares, upon and subject to the terms and conditions hereinafter set forth.

(balance of the provisions can be the same.

SCHEDULE 2

Checklist for Shareholders' Agreements

1. Identify parties

- names
- addresses
- *determine if other corporations are controlled by any of the shareholders*

2. Describe the business of the Corporation

3. List authorized and issued shares and identify all registered shareholders

- meetings of shareholders
- quorum
- number of votes required for ordinary resolutions
- items requiring unanimous consent?
- *note if there are assignments of right to vote and consider effect on control*

4. List of directors

- quorum
- number of votes required for ordinary resolutions
- items requiring unanimous consent
- casting vote?
- notice for meetings

5. List officers

- term

- authority to sign cheques
- authority to execute contract

6. Identify accountants, bankers

- procedure to change

7. Capital requirements

- order for providing capital
- loans and guarantees by shareholders
  - interest rate
  - repayment terms
  - default provisions
  - NB: eliminating votes on default may result in control by other shareholders

8. Restrictions on Transfers

- permitted transfers
- family members, controlled corporations, trust

9. Sale Provisions

- Shot gun
- Put or call - NB consider effect on control
- Retirement
- Termination of Employment
- Death
- Disability
- Bankruptcy

10. Method of Purchase/Sale

- cross purchase
- purchase for cancellation
- determination of value/price
- payment terms

11. Life Insurance

12. Valuation

13. Non competition/Non solicitation