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## Your Shareholders' Agreement

*Why it's important to review previously made commitments*

BY MIKE DEBOSKI

*Unfortunately Shareholder Agreements are often one of those documents that is placed in the back of the filing cabinet and forgotten about for years.*

Since the Shareholders' Agreement has no relevance to the day-to-day operations of the business, or even at annual meetings, it can easily be forgotten. The Agreement really doesn't mean anything until misunderstandings arise or a share transaction is about to occur. Then the Agreement becomes highly relevant!

At least two or three articles of the Agreement are dedicated to the transfer of shares when certain events occur. These events usually involve such occurrences as a matrimonial dispute, a long term disability or a death of one of the shareholders. It is in these articles that terms of the sale will be stipulated: what the price will be, who the buyer will be and where the money will come from.

For most business people, a lot has changed over the years. The value of the business has increased, they are subject to different tax implications and perhaps even personal objectives and expectations have changed. An outdated Agreement can result in a significant erosion of wealth when one of the triggering events occurs. Good planning dictates that commitments made some years ago should be reviewed in light of current realities.

## When expectations change

Sometimes plans for future ownership have a way of changing over the years. For example, shareholders may have originally committed to surviving partners buying the shares from the estate when one of the shareholders dies. However, years after the Agreement was put in place, second generation family members may have become actively involved in the business and may intend to make it their career. The original Agreement may also contradict a more current objective of sons or daughters becoming shareholders. Unless the Agreement is changed to reflect this new expectation, children could find themselves left out of the business someday. If a triggering event were to occur, they could be without a legal claim to the shares or without finances to complete a transaction for the shares.

## The financial realities of buying the shares

Typically, Agreements stipulate that shares will be purchased at fair market value when one of the triggering events occurs. While these terms may have seemed reasonable when the Agreement was first drafted, significant growth in the business could make the price and terms unbearable in today's realities. Where will the money come from? A troublesome reality may occur and a departing shareholder, or their family, could continue to hold shares in the company.

## Tax realities when shares are sold

When shares are purchased under the terms of a Shareholders' Agreement, there are typically three potential purchasers: the remaining shareholders, Holding Companies of the remaining shareholders or the company repurchasing the shares owned by the departing shareholder. From the perspective of the Canada Revenue Agency, each of these transactions is treated differently for tax purposes. And to add confusion, the tax brackets on each of these transactions have changed in recent years. An Agreement that is out of touch with these realities could result in:

- Forfeiting the Capital Gain Exemption
- An unfair distribution of "tax fee" dividends through the Capital Dividend Account (CDA)
- A further unfair distribution of "tax preferred" dividends paid out of

## the General Rate Income Pool (GRIP)

Ignoring the current tax treatment could mean unexpected disputes when a share sale occurs, the very thing the Agreement should be preventing. This is even more troublesome if the sale is the result of the death of a shareholder. Skillful co-ordination of insurance funding strategies with current tax laws can prevent such problems from arising.

## Using insurance to purchase the shares

A well written Shareholders' Agreement will make provision for shares to be transferred if a shareholder should experience a loss of health that prevents him or her from continuing to work. Most commonly, this transfer of shares will occur after a one year period of disability.

Disability insurance products that provide a lump sum payment of money to use for the purchase of shares from a disabled shareholder are available in the marketplace. Business owners ought to consider these products as a way of funding this potential need for cash. Otherwise, they may be left with a financial obligation that could seriously restrict operating cash flow for a number of years.

Likewise, Shareholders' Agreements should make provision for shares to be transferred upon the death of a shareholder. It may be obvious that life insurance is an effective way to fund for this eventuality. What is not so obvious is that life insurance proceeds that are payable to a corporation attract favourable tax features that are unavailable to any other cash injection into the company. These tax benefits shouldn't be overlooked.

Insurance products and strategies have evolved to become not only risk management tools but also "living buy-out" and "tax planning" tools. As businesses mature, a more creative use of insurance solutions is often a way to initiate a succession plan, and consequently Shareholder Agreements need to be re-structured to accommodate these transactions.

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*Deboski & Company*

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