Planning a smooth business succession with buy-sell agreements

A buy-sell agreement allows for the smooth transfer of shares.

Buy-sell agreements: an integral part of a successful business succession plan

A private corporation consisting of more than one shareholder often has an agreement in place to deal with the death, serious illness or retirement of one of its shareholders. This agreement, known as a buy-sell agreement, characteristically provides for the sale of shares of the withdrawing shareholder and the acquisition of those shares by the remaining shareholders. In addition, this agreement creates a degree of liquidity for the usually illiquid shares of a private corporation.

Buy-sell agreement

A buy-sell agreement allows for the smooth transfer of shares or other business assets from a withdrawing shareholder to the remaining shareholders of a corporation. Its primary purpose is to facilitate this transition without jeopardizing the financial well-being of the withdrawing shareholder and his or her family, or the financial health or viability of the corporation.

The common elements of a buy-sell agreement are:

- A triggering event (such as death, disability, retirement)
- A fixed price or valuation method for the business assets
- The manner in which the purchase will be financed

Funding the buy-sell agreement

Financing or funding the buy-sell agreement is one of the common elements that must exist in order for the agreement to be brought to fruition. This funding ensures that money is available to purchase the shares of the withdrawing shareholder.

Some funding options

Establish a sinking fund

A sinking fund is a fund designed to accumulate over a period of years, by means of regular deposits and earned interest. Very few businesses have the resources available to establish a sinking fund, and the amount of the fund may be inadequate if the withdrawing shareholder leaves prematurely.

Obtain a loan from a financial institution

Few institutions will consider lending to a company, especially where the withdrawing shareholder is also a key person.

Buy out the departing shareholder's shares via installments

This could jeopardize the financial well-being of the company if the installments are to be paid for a lengthy period of time (e.g. 20 years) as the company will receive no value for those payments.

Insurance

Life insurance, disability (DI) and critical illness (CI) insurance are the primary vehicles used to fund buy-sell agreements since they are typically the least costly alternatives, and provide an immediate influx of cash. As a result of the unique attributes of insurance products, they may also provide significant tax or business continuation benefits to the withdrawing shareholder, and in the event of death, the surviving shareholders.

There are various ways of structuring buy-sell agreements using insurance. To determine which structure is the most appropriate you first need to decide whether to fund the arrangement with corporate-owned (corporation pays the premiums) or personally owned (shareholder pays the premiums) insurance.

Some considerations

To arrive at this decision, the following must be taken into consideration:

Administration

When numerous shareholders exist, it can become complicated for each shareholder to own policies on the lives of all of the others. It can also be quite costly when you account for the aggregate premium costs. With corporate-owned insurance, only one policy is required, which provides for ease of administration and lower aggregate premium costs.

Protection from creditors

When a buy-sell agreement is funded with corporate-owned insurance, the proceeds payable to the corporation on the death of one of the shareholders are subject to the claims of the corporation's creditors. With personally owned insurance, the proceeds payable to the shareholder are creditor protected (although they may not be protected from the claims of the shareholder's creditors). Speak to a legal advisor to discuss the requirements to qualify for creditor protection.

Tax advantage

Life insurance premiums are generally not deductible, which means that it may be more advantageous for a corporation in a lower tax bracket to pay the premiums to fund a buy-sell agreement than the individual shareholders, who may be in a higher tax bracket. For example, an individual shareholder with a marginal tax rate of 45% would require $1,818 of pre-tax income to pay a $1,000 insurance premium. A corporation paying tax at a rate of 20% would require only $1,250 of pre-tax income to pay the premiums.

Ensuring payment of premiums

When a buy-sell agreement is funded with personally owned insurance, it may be challenging for one shareholder to be certain that the other shareholders are meeting their obligations by making the necessary premium payments. The policing of premium payments is not required with corporate-owned insurance.

Insurance costs

If one shareholder is in poor health or is significantly older than the other shareholders, personal ownership of the policies places a heavy premium burden on the other shareholders. Whereas with corporate-owned insurance, the cost is shared among the shareholders according to their pro rata interest in the corporation.

For more information, please contact us.