The Navigator

RBC WEALTH MANAGEMENT SERVICES

Cafferky Wealth Management Group of
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Buy-Sell Agreements — Funding Options

Part II — Ensuring the orderly transfer of business interests in a corporation

A buy-sell agreement is a legally binding arrangement that guarantees the sale and purchase of a business interest in the event of a business owner's death, disability or retirement. This article is intended to provide you with the advantages and disadvantages of funding a buy-sell agreement with corporately owned or personally owned insurance. This is the second article in a three part series.

Buy-sell funding

As discussed in the first article of this three part series, life insurance is the preferred funding option in a majority of buy-sell agreements. In the event of death, life insurance provides funding and the proceeds are received tax-free.

Personally owned insurance

There are many ways to structure an insurance financed buy-sell agreement. The following example, often called the "personally owned cross-purchase method", is the simplest. Under this structure, the buy-sell agreement is between shareholders or the shareholders and a trustee (a trustee is used to simplify the ownership of insurance) and does not involve the corporation.

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Example

Ms. Clare and Mr. Lane are the owners of all of the shares of CLANE, a Canadian-Controlled Private Corporation (CCPC) carrying on active business in Canada. The shareholders' agreement provides that in the event of death, the surviving shareholder will buy, and the estate of the deceased shareholder will sell, the shares formerly held by the deceased shareholder. The purchase will be funded by personally owned life insurance.

Ms. Clare is the policyholder, premium payer and beneficiary on the life of Mr. Lane; Mr. Lane is the policyholder, premium payer and beneficiary on the life of Ms. Clare.

Advantages

- This is a simple structure and easy to implement;
- The life insurance proceeds provide the surviving shareholder with the funds to buy the shares;
- The structure allows the surviving shareholder to increase the cost basis of her shares by the amount paid to the deceased's estate; and
- This structure allows the deceased shareholder's estate to take advantage of the $750,000 capital gains. exemption, to the extent that the shares qualify.

Disadvantages

- The premiums for the life insurance are paid with personal after-tax funds (taxed at the shareholder's marginal tax rate), which is typically a higher after-tax cost than corporately owned insurance;
- If there are multiple shareholders, this structure may become difficult to manage; and
- The shareholders may need to negotiate the allocation of premiums if their ages, health status or ownership in the corporation differ.

Corporately owned insurance

The following example, often referred to as the "corporately owned cross-purchase method" or "promissory note method", is just one method of structuring the buy/sell obligation using corporately owned insurance. Under this structure, the corporation is the policyholder, premium payer and beneficiary of the life insurance policies on the lives of the shareholders.

The following example, often referred to as the "corporately owned cross-purchase method" or "promissory note method", is just one method of structuring the buy/sell obligation using corporately owned insurance.

Example

Ms. Clare and Mr. Lane own shares of CLANE, a CCPC carrying on active business in Canada. The corporation has a fair market value (FMV) of $2 million. Their ownership is a 50/50 split. To fund the buy-sell agreement in place between Ms. Clare and Mr. Lane, corporate owned life insurance is used whereby CLANE purchases life insurance contracts on the lives of both Ms. Clare and Mr. Lane in the amount of $1 million each. CLANE is the premium payer, policy owner and beneficiary.

Unfortunately, Mr. Lane dies.

In accordance with the buy-sell agreement, Ms. Clare purchases Mr. Lane's shares from his estate at fair market value using a promissory note representing the purchase price. The life insurance company pays the $1 million death benefit directly to CLANE. CLANE then uses the insurance proceeds (in excess of the insurance policy's adjusted cost basis) to pay a dividend to Ms. Claire. CLANE elects to pay the dividend out of its capital dividend account to Ms. Clare on a tax-free basis. Ms. Clare uses the funds to retire the promissory note.

Ms. Clare now has 100% ownership of CLANE, and Mr. Lane's estate has $1 million in cash.

Advantages

- This structure is relatively easy to establish and administer.
- The structure may allow the deceased shareholder's estate to take advantage of the $750,000 capital gains exemption, to the extent that the shares qualify.
- The structure allows the surviving shareholder to increase the cost basis of her shares by the amount paid to the deceased's estate
- The life insurance proceeds provide the funding for the buy-sell commitment
- The corporation receives the life insurance proceeds tax-free.
- Fewer policies are required than with personally owned insurance.
- Premium disparities between the shareholders are not an issue.
- Premiums are paid with corporate after-tax funds. Premium payments are not considered a shareholder's benefit because the corporation is the beneficiary of the insurance policy.

Premium payments are not considered a shareholder's benefit because the corporation is the beneficiary of the insurance policy.

Disadvantages

- Insurance proceeds may be subject to claims from the company's creditors.
- The corporation may need to meet solvency tests before it can make a dividend payment.

Another method of structuring an insurance financed buy/sell agreement at death is the "corporate redemption method". Under this method, the corporation is the owner and beneficiary of the life insurance policy on the life of each shareholder. On the death of a shareholder, the life insurance proceeds would be paid to the corporation and it would use the proceeds to repurchase or redeem the shares of the deceased shareholder from the deceased's estate.

It is possible to use a combination of both methods in what is called the "hybrid method". Under this method, some of the deceased's shares will be purchased by the surviving shareholder(s) and some of the deceased's shares would be repurchased or redeemed by the corporation.

There are different methods of structuring the buy/sell agreement using life insurance as the funding mechanism in the event of death. The manner in which the buy/sell agreement is structured (whether via a share purchase by the surviving shareholder(s), a repurchase or redemption by the corporation, or a combination of both) will have a tax impact on the deceased, the surviving shareholder(s), the corporation and the deceased's estate. Which arrangement is most beneficial will depend on the facts and circumstances of the parties involved.

If you have any questions or require clarification on any of the issues discussed in this document, you should discuss these with a qualified tax advisor. You should obtain professional advice before acting on any of the information in this article. This will ensure that your own circumstances have been considered properly and that action is taken on the latest information available.

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