The Navigator

RBC WEALTH MANAGEMENT SERVICES

Buy-Sell Agreements — The Basics

Part I — An integral part of a successful business succession plan

This article is intended to provide you with a general overview of buy-sell agreements and the funding options available. Due to the variety of funding options, instead of one lengthy article, we have broken the content into three separate articles. This is the first article in the series.

A private corporation consisting of more than one shareholder often has an agreement in place to deal with the death, disability or retirement of one of its shareholders. This agreement, known as a "buy-sell agreement", provides for the sale of shares by the withdrawing shareholder and the acquisition of those shares by the remaining shareholders or third parties. Additionally, the agreement could provide for the purchase or redemption of those shares by the corporation for cancellation. In addition, this agreement creates a degree of liquidity for the typically 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 departing or disabled shareholder to the remaining shareholders of a corporation or to a third party. Its primary purpose is to facilitate this transition without jeopardizing the financial well-being of the departing or disabled shareholder and his or her family, or the financial health and viability of the corporation.

The common elements of a buy-sell agreement are:

- A triggering event (such as death, disability, retirement, or third party offer);
- A fixed price or valuation method for the shares; and
- The manner in which the purchase will be financed.

Funding the buy-sell agreement

Financing or funding for 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 departing or disabled shareholder.

Some funding options are:

- **Establishing a sinking fund** — A sinking fund is simply a pool of money a corporation sets aside for a specific purpose. Very few businesses have the resources available to establish a sinking fund, and the amount of the fund may be inadequate if the departing shareholder leaves prematurely.
- **Obtaining a loan from a financial institution** — As a condition of lending, a financial

institution may place debt covenants and other encumbrances on the company which may restrict the ability of the company to use its assets, or to pay dividends. Additionally, institutions may not be willing to lend to a company where the departing shareholder is also a key person to the company's success. This methodology also dilutes the value of the shares of the other shareholders until the loan is repaid.

- **Buying out the departing shareholder's shares via instalments** — This could jeopardize the financial well-being of the company if the instalments are to be paid over a lengthy period of time (e.g. 20 years) as the company will receive no value for those payments.
- **Buying life insurance** — Life insurance is typically the least costly alternative and it provides an immediate influx of cash. As a result of its unique tax attributes, life insurance may also provide significant tax benefits to the departing shareholder, and in the event of death, the surviving shareholders. As a result, life insurance is the preferred funding option in a majority of buy-sell agreements.

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Funding a buy-sell agreement with life insurance

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

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 the other shareholders. It can also be quite costly when you account for the aggregate premium costs. With corporately owned insurance, only one policy for each shareholder is required, which provides for ease of administration and lower aggregate premium costs.
- **Potential Protection from creditors** — When a buy-sell agreement is funded with corporately 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 may offer asset protection from the creditors of the corporation (although they may not be protected from the claims of the shareholder's creditors).

Please be aware that if there are any known or potential creditors, any structure chosen may be ineffective to protect against claims by existing or future creditors. It is essential that a qualified legal advisor is consulted regarding any asset protection options.

- **Tax leverage** — 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 15% would require only $1,176 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 corporately 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 corporately owned insurance, the cost may be shared among the shareholders according to their pro rata interest in the corporation.

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.

To determine which structure is most appropriate, you first need to decide whether to fund the arrangement with corporately owned (corporation pays the premiums) or personally owned (shareholder pays the premiums) life insurance.

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