

# TAX-EFFICIENT BUSINESS BUY-SELL AGREEMENTS

Effective use of life  
insurance funding to  
support the transfer  
of a small business



## Personally-owned insurance

### Parties

The parties to the buy-sell agreement are the shareholders, but not the corporation (as it is the thing being bought and sold). This is often called 'criss-cross' insurance because each shareholder owns insurance on the lives of the other shareholder(s).

### Burden of premiums

Ironically, premiums are more costly to younger shareholders and those at a lower insurance risk because the event against which each shareholder is insuring is the death or disability of the other shareholder(s).

### Cost of premiums

Shareholders pay the premiums out of their own pockets using personal after-tax dollars, which is to say that this is not a taxdeductible expense. Personally-owned insurance is probably the easiest and most appropriate set-up where the deceased's lifetime capital gains exemption is still or will be available. As is the case with life insurance generally, the surviving survivor(s) receive insurance proceeds tax-free. The survivor then purchases the shares of the deceased shareholder from the deceased shareholder's estate.

## Corporate-owned insurance

### Parties

The corporation is a party to the buy-sell agreement along with shareholders, each with rights and obligations as agreed upon. The corporation owns the policies, pays the premiums on and is beneficiary of the policies on each of the shareholders' lives.

### Burden of premiums

Because the corporation pays the premiums, the cost of the insurance is borne proportionate to shareholder interests. In effect the shareholders have foregone dividends in favour of having the corporation pay the insurance premiums.

### Cost of premiums

Payment of the premiums is not a tax-deductible expense. That is to say that the corporation pays with after-tax dollars. Nonetheless, it is likely less expensive than personally-owned insurance as the corporation's tax rate is usually lower than shareholders' tax rates, meaning that its after-tax dollars are less costly than personal after-tax dollars.

Corporation receives proceeds tax-free. Steps can then be taken to have the shares of the deceased shareholder redeemed by the corporation and/or transferred to the other shareholders.

# ROLE OF INSURANCE AS A BUY-SELL FUNDING SOURCE

Generally shareholders will have committed the bulk of their resources to the ongoing business. Accordingly (in the case of death or disability particularly), insurance is often the only realistic means of providing adequate buy-sell funding:

## Un-funded

- Neither corporation nor shareholder has adequate cash
- 'Stranger' shareholder may come in
- Company's continuation compromised

## Sinking fund

- High risk exposure in early years
- Slow growth (protecting capital)

## Insurance funded

- Determined cash requirements can be accurately fulfilled
- Cash availability is virtually immediate
- 'Business as usual' for the corporation
- Deceased's estate receives fair value for the shares

## Importance of an...

### Executed 'Buy-Sell' agreement

A shareholders' agreement is a contract stating how shareholders commit to deal with one another. Part of that agreement – and possibly standing on its own—is the 'buy-sell' provision that may be invoked upon the occasion of certain future events:

- Disagreement
- Departure (amicable)
- Disability
- Death

## Content of the agreement

The buy-sell addresses the triggering conditions that will force a sale (and a corresponding purchase) of a shareholding, along with the valuation method, the buy-sell procedure, and the funding source.

## Integrated with other wealth planning

In support of this business planning activity, at a minimum shareholders should have in place their wills and powers of attorney, and consider advanced plans such as trusts, estate freezes and domestic contracts.

## Structural flexibility

Where the funding is corporate-owned, the sale should be able to proceed as a personal buyout or corporate redemption.

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