# KEEP ON KEEPING ON: A Properly Structured and Funded Buy/Sell Clause Can Help Ensure the Continuity of a Business

There are numerous reasons why businesses with multiple shareholders require a shareholders' agreement ("Agreement"). A good Agreement provides a clear roadmap of how decisions are to be made upon the occurrence of potential events and conflicts. Such a roadmap is often most needed upon the death of a shareholder.

Generally, this event requires the buy-out of the deceased shareholder's shares in the company. Without a properly structured and funded buy/sell clause ("Buy/Sell"), the shares of the deceased will often pass through their estate to their spouse and/or kids. This occurs far more often than one might imagine and can be disastrous for both the surviving shareholders and beneficiaries of the deceased.

When there is no Buy/Sell, or the clause isn't adequately funded, and the family of the deceased inherit the shares, one or more of the following often occur:

1. The family of the deceased does not get along with the surviving shareholders;
2. The family members inheriting the shares are incompetent and have voting rights (or even worse, voting control);
3. The inheriting family wants to sell and the surviving shareholders want to buy but they cannot agree on a price; and
4. Perhaps they agree on a price but lack the necessary funds to complete the sale.

The objective of a Buy/Sell is to provide liquidity to the exiting shareholder and ensure continuity of the business and a smooth ownership transition for the remaining shareholders. A well-structured Buy/Sell provides greater certainty to the shareholders, their families and all stakeholders of the business (including employees) that the business can survive the death of a shareholder.

## Funding the Buy/Sell Clause

Negotiating the Buy/Sell can be amicable or, at times, incredibly contentious. It can be difficult to tell your business partner of decades that you do not want to be partners with their child and/or spouse. After months of negotiating, whether amicable or not, and a Buy/Sell has been agreed upon, that clause will still need to be properly funded.

Proper funding is required to ensure that the Buy/Sell works as intended. When the remaining shareholder is legally obligated to purchase the shares and proper funding is not in place, there are typically three options:

## Options for Funding the Buy/Sell Clause

1. **Borrow the funds from a bank to fund the purchase of the shares**: Banks (regardless of an existing relationship) will often not provide a loan for the purposes of buying the shares of a deceased shareholder. This is particularly the case when the deceased shareholder was fundamental to the success of the business.

2. **Use of personal and corporate cash to fund the purchase**: This option requires after-tax capital to be invested and reserved for purposes of funding the Buy/Sell. Businesses sometimes lack the necessary liquidity as such cash is

reinvested directly in the business or used to fund the lifestyle of the shareholders. Even in the case where funds were allocated for this purpose, should the need arise for capital in the future (either for growth or due to strained finances), most businesses would access this 'reserved' cash rather than borrowing the required funds from the bank. This option is typically thought as the most unrealistic.

3. **The estate/heirs are entitled to a percentage of profits from the business until the purchase price has been satisfied**: Purchasing over time has a clear risk to the heirs should the business not produce the same income as prior to death of the shareholder and there is a burden on the business to continue the payments without interruption. There may also be a need for the family of the deceased to access capital more quickly.

   Apart from the financial risks associated with the options above, it should not be forgotten that following the death of a shareholder, his/her family are dealing with issues beyond those of the business. The business will also likely experience difficulties following the death of a key shareholder and additional complications will make a difficult time more difficult. Having instant liquidity can mitigate these issues, which brings us to life insurance as the primary option for funding the Buy/Sell.

4. **Life Insurance to Fund the Buy/Sell Clause**: Life insurance provides certainty and liquidity from the onset without interruption or complications to the business or the estate. The insurance proceeds are paid to the business tax-free and can be used for funding the Buy/Sell in both a timely and tax-efficiently manner. Life insurance policies are acquired on the life of each shareholder with a death benefit equal to the value of that shareholder's shares as specified or calculated under the Agreement.

We typically recommend term insurance to fund the Buy/Sell. Term insurance is cost-effective and provides flexibility for future planning should the business be sold or fail.

## Structuring the Buy/Sell Using Insurance

Generally, there are two basic ways of structuring the use of insurance to fund the Buy/Sell: the surviving shareholder purchases the deceased shareholder's shares, or the corporation can purchase the deceased shareholder's shares by way of a redemption. The Agreement can be drafted/amended to reflect how the shareholders would prefer to structure the Buy/Sell**.**

If the Agreement provides that the surviving shareholders will purchase the deceased's shares, then the Buy/Sell may be funded with insurance owned by the shareholders using the "Criss-Cross Method" or it may be funded with insurance owned by the corporation using the "Promissory Note Method". Conversely, if the Agreement provides that the corporation will purchase the shares, then the Buy/Sell can be structured using the "Corporate Redemption Method".

**a)** **Criss-Cross Method**: Under this method, the shareholders each purchase a life insurance policy on the life of the other shareholder and names themselves as beneficiary. Upon death of a shareholder, the surviving shareholder uses the insurance proceeds paid from the deceased's life insurance policy to purchase the shares from the deceased shareholder's estate.

   We do not often recommend this method as the premium amount will differ based on the ages and health of the shareholders – why should one shareholder have a larger cost to protect the same asset. Moreover, each shareholder will need to trust that the other continues to make the payments. The failure of a shareholder to make such payments is often not discovered until it is too late (at death).

b) **Promissory Note Method:** With this method, the corporation purchases a life insurance policy on the life of each shareholder. The

*A well-structure Buy/Sell provides greater certainty to the shareholders, their families and all stakeholders of the business.*

corporation is named as the beneficiary of the policies and the Agreement is drafted to require the surviving shareholder to purchase the shares of the deceased shareholder. However, instead of purchasing the shares for cash, the Agreement will specify that the surviving shareholder will purchase the shares for a promissory note. Upon the death of one of the shareholders, the corporation receives the insurance proceeds and pays the proceeds to the surviving shareholder or their respective holding company allowing them to satisfy the promissory note.

This is often a preferred method for several reasons. Firstly, the policies are both paid by the corporation, so the inequity and costs variances described above are negated. Secondly, the deceased shareholder's estate can use the capital gain exemption. Lastly, the surviving shareholders can effectively bump the ACB of their shares.

For example, lets look at a corporation ("Opco") with two shareholders – Carl and Bob. Carl and Bob each own 100% of the shares in their respective holding companies, which in turn each own 50% of Opco. Opco acquires term life insurance policies on the lives of Carl and Bob equal to $5m (the FMV of their shares).

After Carl passes away, the insurance proceeds from the term policy on his life are paid tax-free to Opco and credited to the CDA of Opco. Bob's holding company ("BobCo") purchases the shares from Carl's holding company ("CarlCo") for a promissory note equal to $5m. Opco then pays a capital dividend to BobCo, which then uses the funds to satisfy the promissory note. BobCo now owns 100% of the shares in Opco but with an ACB of $5,000,001 rather than $2.00. Accordingly, when BobCo disposes of those shares, it has decreased the capital gain tax on that disposition in half.

c) **Corporate Redemption Method:** The corporation purchases a life insurance policy on the life of each shareholder, and the corporation is named the beneficiary of each of the policies. Upon the death of one of the insured shareholders, the insurance proceeds flow tax-free to the corporation. The corporation then redeems the shares of the deceased shareholder using some or all of the CDA.

This method is generally preferred when the shareholders have used all or a portion of their capital gains exemption. However, it must be noted that a "stop-loss" rule may apply to this method where a capital loss carry-back is used by the estate. Alternatively, if there is sufficient safe income, an inter-corporate tax-free dividend may be able to be used upon the redemption without triggering 55(2) of the *Income Tax Act* which would recharacterize the dividend as a capital gain.

Another important distinction is that under this method, the surviving shareholder will not get a step-up in basis in the ACB of the shares acquired as a result of the redemption. On the other hand, if due to the stop-loss rule, only 50% of the CDA can be used on the redemption, the surviving shareholders will retain the balance of the CDA for future use.

We always recommend drafting the Agreement to provide flexibility for changes in the business and tax rules whereby the corporation and its shareholders can decide what method to use. The language we recommend allows for a hybrid approach using both the Promissory Note and Corporate Redemption Methods to maximize the capital gain exemption and a tax-free redemption using the CDA without triggering the stop-loss.

## Capital Gain Tax Liability of Disposition of the Shares by the Deceased

Under normal circumstances, when a spouse dies, all property of the deceased can pass to the surviving spouse as a tax-free rollover so long as the property vests in the spouse. However, the Canada Revenue Agency ("CRA") takes the position that a mandatory Buy/Sell negates the ability to use the spousal rollover rules. The mandatory Buy/Sell, in the CRA's view, prevents the shares from vesting. Therefore, no spousal rollover is available, and the full capital gain will have to be reported on the deceased's final return.

Accordingly, when a Buy/Sell has been included in an Agreement, consideration must also be given to the eventual capital gain tax resulting from the disposition of the shares under this clause. While we generally advise to use term insurance to fund the Buy/Sell as discussed above, we typically recommend a permanent policy to be acquired personally or by each respective holding company to fund the capital gain tax liability.

The main reason for this is that term insurance for the Buy/Sell serves a singular purpose. A permanent policy in the holding company can be used not only to pre-fund the tax liability but can also be used for a tax-efficient inter-generational transfer of wealth.

## Conclusion

A properly structured and funded Buy/Sell can seamlessly transition the business after the death of a shareholder while also providing the financial certainty and immediate liquidity for the heirs of the deceased shareholder.

While this seems relatively straightforward, many insurance advisors lack the expertise to advise on anything beyond the funding. It is essential not only look at funding the Buy/Sell but also how best to structure it and the tax consequences associated with the triggering of it.

Sterling Park is a leading Canadian insurance advisory firm creating highly innovative and comprehensive solutions. We are not typical insurance advisors – our Partners are experts in tax law, finance, estate planning and navigating complex family dynamics.

**Jonah Mayles | LLB**
PARTNER, TAX & ESTATE PLANNING
647-694-1646 jonah@SPFgrp.com