BY GLENN STEPHENS

Reviewing Agreements

How to structure life insurance for shareholders

The use of corporate-owned life insurance to fund shareholders' agreements is a staple of the business market. The benefits of a funded buyout on death are obvious to an insurance advisor. And in most cases a client's tax and legal advisors will agree that insurance is the best way to protect shareholders and their families in the event that the unexpected occurs.

Having said that, agreements are often deficient in how they deal with a funded buyout on death. This creates opportunities for knowledgeable insurance advisors who are comfortable reviewing agreements. The more effort you put into reading and understanding these agreements, the more you will be seen as a resource to clients and to their other professional advisors, who may not necessarily be well-informed on insurance planning strategies.

Let's consider some key areas to look out for:

STRUCTURE OF THE BUYOUT ON DEATH

In most cases, a shareholders' agreement will provide that, on a shareholder's death, the shares will either be redeemed by the corporation or purchased by the surviving shareholder(s). There are many potential buyout structures and no single approach that works in all cases. An insurance advisor can assist in the analysis of the agreement by getting answers to the following questions:

• Does the agreement refer to the use of life insurance as a funding vehicle? Most agreements will anticipate the use of insurance, but a surprising number provide for an unfunded buyout on death. In that case, there is an opportunity for the insurance advisor to show the clients that, in most cases, life insurance is the most cost-effective and tax-effective funding alternative.

• Does the agreement make reference to the capital dividend account ("CDA") and how it is to be used in the buyout? This is a fundamental part of the tax planning when corporate-owned life insurance is used as a funding vehicle, and should be specifically addressed in the agreement.

• Is the buyout on death mandatory or optional? In most cases, it is recommended that a buyout on death be mandatory, so all parties know exactly what will happen if a shareholder dies. This is especially true where insurance proceeds will be available.

OWNERSHIP OF INSURANCE

Most agreements will provide for the corporation, which is typically an operating company ("Opco"), to be the owner and beneficiary of the insurance. While this is common, it is in fact something to be avoided if possible.

Having Opco own the insurance increases the likelihood of having to transfer ownership of the policies in the future. For example, it is common for an individual to sell his or her Opco shares at the time of retirement. If the selling shareholder wants to obtain the policy for personal planning needs, the tax cost of transferring the policy can be prohibitive.

In cases where Opco shares are owned by an individual's holding company ("Holdco"), it is often advisable for the Holdco to own the policy on the life of its shareholder, with Opco named as beneficiary for as long as the shareholders' agreement is in place. If Holdco sells its Opco shares at a later date, it will not be necessary to change ownership of the policy; changing the beneficiary is all that will be needed.

If the corporate structure or other factors require the policies to be owned by Opco, the agreement should usually provide that any shareholder selling shares during their lifetime has the option to purchase the policy on his or her life, perhaps for the greater of the policy's cash surrender value and one dollar.

SHARE VALUATION

In most cases, the price established for shares bought and sold on death should be fair market value, although this can admittedly be difficult to determine in the case of a private corporation. Valuation is a key piece of information for the insurance advisor, since this will help determine the amount of insurance that is required.

Agreements will sometimes provide for shareholders to meet annually and agree upon the value of their shares. Typically, it is expected that the yearly updated value will be added to a schedule attached to the agreement. This may make sense in theory, but in practice most shareholders do not have the time or the inclination to perform this function.

In other cases, the agreement provides a formula for calculating fair market value. This can provide an objective method of determining value although there is a risk that the formula will not remain current and therefore not provide an accurate measurement when the time comes.

In many cases, the preferred route will be having the parties agree on a purchase price when a shareholder dies. In the event the parties are unable to agree, the agreement can provide for the appointment of an independent valuator.

Whatever valuation method is used, the agreement should clearly state that the shares' value will not include any amount in respect of the insurance proceeds that have been paid to the corporation on the shareholder's death. Insurance is simply a funding vehicle and generally not part of long-term corporate value.

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