WOOD GUNDY

BUSINESS SOLUTIONS BUY/SELL AGREEMENTS

As a business owner, ensuring the longevity of your company is an important, and often overlooked, part of your financial plan. While business partners usually believe they will be in business together well into the future, this is not always the case. There are numerous situations that can impact the success of your business which deserve serious consideration.

Your business can be disrupted if one partner dies or leaves due to permanent disability, retirement, bankruptcy, divorce or an unresolved dispute between business owners and shareholders.

If your business loses an owner, the remaining partners must decide how the business will continue. You generally have four options to consider:

1. Close down the business – after all the time, energy and money invested, this may not be a practical option
2. Continue the business with a new partner
3. Sell your shares – who will buy them and at what price?
4. Purchase the shares from the deceased owner's estate

A Buy/Sell Agreement can protect your business from the potential damage of losing a partner. This type of agreement covers both the terms of ownership and the operation of your business, and should be a crucial element of your business plan. A Buy/Sell Agreement addresses the death, disability and retirement of one of the owners, as well as disagreements about ownership and operation of the business that can result when an owner wants to exit the partnership. The agreement often includes a formula or process for valuing the business to simplify the buy-out of an owner.

Funding a Buy/Sell Agreement

Proper funding must be in place to ensure a Buy/Sell Agreement is viable. Without proper funding, the agreement can fall apart. There are a number of ways you can fund a Buy/Sell Agreement including:

Accumulated savings

After-tax capital is invested in an investment earning taxable income. Typically, businesses do not always have large sums of liquid assets on hand as money is put to work directly into the business, and as such this strategy may not be realistic.

Borrow the funds from a bank

Borrowed money must be repaid using after-tax dollars and the interest on the borrowed funds may not be tax deductible. In addition, loss of a key person may impair the credit-worthiness of the business and other partners, making this option out of reach.

Installed payments to heirs by buyers

Purchasing over time has risks if the business fails, making the principal and interest payments burdensome.

Life insurance

Provides a financing guarantee from the beginning. Death proceeds are generally tax-free and the cash value can be used for funding a buyout due to retirement or disability of one of the shareholders.

Buy/Sell Agreements deal with:

- Who will buy your company's shares
- When the sale will take place
- The terms of the sale
- Where the money to buy the shares will come from
- What the purchase price will be

Advantages of a Buy/Sell Agreement:

- Provides a guaranteed buyer for the business interest
- Guarantees the owner or heirs a fair selling price
- Provides the owner and their family with an income producing asset
- Minimizes interruption of business operations

Questions to ask yourself about your Buy/Sell Agreement:

- Does it cover death, disability, retirement and disagreement?
- Does it include a workable and accurate business valuation formula for the business?
- Is the agreement funded, and if so, is it set up in the most efficient manner?

Using insurance solutions to fund Buy/Sell Agreements

There are three main methods to fund these types of agreements:

Criss-cross method

Each shareholder purchases a life insurance policy on the life of the other shareholder(s) and names themselves as beneficiary. Subsequently, the shareholders and company complete a Buy/Sell Agreement that requires the surviving shareholder(s) to purchase the shares of the deceased shareholder, usually at fair market value (FMV). Upon the death of a shareholder, the surviving shareholder(s) uses the insurance proceeds paid from the deceased shareholder's life insurance policy to purchase the shares fromthe deceased shareholder's estate. Benefits of this method include:

- Estate may use Capital Gains Exemption rules.
- Insurance proceeds may be protected from creditors and are not subject to double taxation or stop-loss rules.

Promissory note method

With this method, the operating company purchases a life insurance policy on the life of each shareholder. The company is named as the beneficiary of the policies. The shareholders and the company then complete a Buy/Sell Agreement requiring the surviving shareholder(s) to purchase the shares of the deceased shareholder at FMV, using a promissory note. Upon the death of one of the shareholders, the company receives the insurance benefit and pays the proceeds to the surviving shareholder(s) as a capital dividend, allowing them to honour the promissory note. Benefits of this method include:

- Premiums are evenly shared among shareholders.
- Cost of paying premiums can be significantly lower to the company than if the company provides the shareholders with an after-tax payment to pay premiums.

The Corporate Redemption Method

The operating company purchases a life insurance policy on the life of each shareholder, and the company is named the beneficiary of each of the policies. The main difference between the Corporate Redemption Method and the Criss-Cross and Promissory Note Methods is that the Buy/Sell Agreement requires the company to purchase and cancel (or redeem) the shares of the deceased shareholder. Benefits of this method include:

- All or part of the tax on the gain of the shares is deferred upon the death of the first shareholder.
- Cost of paying premiums can be significantly lower to the company, than if the company provides the shareholder(s) with an after-tax money to pay premiums.
- Premiums are shared proportionately among shareholders.

Of the various alternatives available to fund a Buy/Sell Agreement, life insurance may provide the best solution. By using a Universal Life policy, the cost of the insurance premium may be considerably lower than other options. With a Universal Life policy, the "insurance" and the "savings" elements are unbundled, and the policy owner can choose between a wide range of investment options in which to allocate the savings portion of the premium. Ensuring you have a proper Buy/Sell Agreement in place for your business can help you avoid potential business disruptions that may arise in the event that you lose a partner.

Using life insurance, your CIBC Wood Gundy Investment Advisor, in conjunction with an Estate Planning Specialist[1], can work with you to prepare and implement a proper Buy/Sell Agreement to protect your business.

1 Financial Security Advisor in Québec.

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