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TAXSTRATEGY

Life insurance is the best way to preserve and…

Protect your business

Mark Halpern, CFP, TEP

Building a solid business often requires years of hard work, lots of endurance and time away from family and friends.

If you own an equal share in your business with one or more partners in a private corporation, you must get a plan in place just in case one of you becomes disabled or passes away prematurely.

No one likes to think about getting sick or dying, but every business owner must consider that scenario and answer these questions:

☛ How will the business carry on without you?

☛ Who will open the doors of the office tomorrow if you can't be there?

☛ Do you leave your shares to your spouse who has no idea what's involved in carrying out the business?

☛ Do you leave your share to your children (who may or may not be in the business)? Are they ready to run the business and receive your shares?

☛ Do you want your partner's spouse and his/her lawyers to be your new partner?

Every successful small business owner represents the hub of a wheel connected to many spokes – your spouse, children (in and out of the business), partners, employees, suppliers, lenders and the CRA. Most business owners rarely look after themselves by answering "what would they like to see happen?"

Just as no good estate plan is complete without a will, no good business plan is complete without a shareholder agreement.

When written properly and agreed to by all parties, it will avoid a lot of potential conflicts among shareholders down the road. And life insurance can help you achieve this goal.

A key component of a good shareholder agreement is the buy-sell provisions that make clear how shares will be transferred on retirement, disability, death, bankruptcy or marriage breakdown.

Looking ahead, there are basically four choices if any of these situations occur: Close the business, sell your shares or the sell the business, continue the business with the new owner (for example, the spouse of the deceased owner, or buy the shares from the deceased owner's estate.

If your ideal scenario is the last option, you definitely need a shareholder agreement in place to determine who will buy the shares, what the purchase price will be, and any other terms of the sale.

A properly crafted agreement using life insurance will help reduce taxes, provide for a guaranteed buyer and market for all the hard-earned equity you have put into your business over the years.

When developing a shareholder agreement with life and disability insurance provisions, all parties should have their own independent legal counsel and the agreement itself should be drafted by an experienced lawyer with knowledge and expertise in this area.

Knowing that funding is available is the key to ensuring the agreement follows through. So even though a legal docu-

Mark Halpern, Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP) is President of illnessPROTECTION.com. Mark is one of Canada's top life insurance advisors with special expertise for business owners, entrepreneurs, medical professionals and high-net worth individuals. He can be reached at 905-475-1313.
mark@illnessPROTECTION.com

ment has been drawn up that states the remaining shareholders will buy the departing owner's shares, if no funding arrangement is in place the whole deal will likely collapse.

Consider these options to fund a buy-sell agreement:

- start saving today
- borrow the money from a bank or other lender
- take the funds from current earnings
- sell assets
- buy life insurance, disability insurance or critical illness insurance to provide the funds needed.

The life insurance option usually provides the most cost-efficient way to fund a buy-sell agreement when the owner dies.

Putting an agreement in place

A number of different structures can be used; each has its own tax and legal outcomes.

One structure is for the surviving shareholder(s) to buy the deceased's shares, or the private corporation to buy the deceased's shares by redeeming those shares.

In this scenario, each shareholder of the corporation is the owner and the beneficiary of a life insurance policy on every other shareholder.

If one of the shareholders dies, then the life insurance proceeds are paid to the surviving shareholders who each use the proceeds to purchase the deceased's shares.

The death benefit must be equal to the value of that shareholder's shares, which is calculated or outlined in the agreement.

If surviving shareholders buy the deceased's shares, the buy-sell obligation gets funded with insurance using any one of a number of legal structures with names like "criss-cross," "promissory note method" and "corporate redemption method." There are various hybrids of each.

When considering which of the many different structures to use in a buy-sell agreement, several topics should be addressed

Often in the case of a private corporation, if one shareholder dies, the private corporation will receive the insurance proceeds tax free and use that money to redeem the deceased's shares. I have outlined an example of just one of the many structures you can use in your buy-sell agreement (see box).

When considering which of the many different structures to use in a buy-sell agreement, several topics should be addressed, including whether it is better for the corporation or for the individual to buy the insurance.

Tax leverage, ensuring each shareholder pays his/her premiums, the cost of premiums, the ease of administration, tax complexity and whether creditor protection is in force on the death of a shareholder are important issues that need to be considered.

For example: when it comes to cost, it can be argued that if one of the shareholders is considerably older than the others,

Charlie and Roz – An example

Long-time friends Charlie and Roz are equal shareholders in XYZ Company. They have a shareholder agreement that requires a buyout should one of the shareholders die but they need funding for the buyout so that if one of them dies, the company will have the funds to redeem the deceased's shares.

When Charlie retires 15 years from now at age 65, he intends to implement an estate freeze locking in the value of his shares. This will allow Charlie to pass all future growth of his shares over to his son Jack who is a senior manager in the business.

Charlie's share of XYZ Company is currently worth $1 million. Based on an assumed growth rate of five per cent, Charlie anticipates his shares will be worth almost $2.1 million when he is 65.

Charlie is looking for a cost-effective solution that will provide funding for a buyout if he or Roz dies, with the potential to grow as the value of the business grows.

After talking the matter over with their respective financial advisors they determine that life insurance is the best way to fund a buy-sell at death. If one shareholder dies, XYZ Company will receive the insurance proceeds tax free and use them to redeem the deceased's shares.

For Charlie, this means a life insurance policy can be established with an initial coverage amount of $1 million that grows to $2.1 million by the time he is 65.

or is in poor health, personal ownership of life insurance translates into an unequal financial cost to the younger and healthier shareholders.

In this case, it may be preferable to buy corporate-owned insurance, with the cost shared among shareholders according to their pro rata interest in the company.

On the other hand, the provisions of the Income Tax Act are generally more complex when corporate-owned insurance is used and there could be complications when it comes to creditor protection. In these cases then, private insurance is preferable.

There are many ways to preserve the future ownership of your company. Life insurance stands out because it is tax-free, usually less expensive than other options and most importantly, it is there when you need it most.

Get help from an experienced certified financial planner with trust and estate expertise to help you navigate through the tax implications of setting up a properly structured agreement and the many options you can use life insurance to fund the agreement.

Working in tandem with a specialized lawyer will give you the peace of mind knowing that your future and that of your family is secure. ❏