

Brooks Newsletter

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“Troubleshooting Your Business”: Life Insurance Requirements

This is our second in a five-part series called “*Troubleshooting Your Business*” in which we discuss topics that interest Canadian business owners and operators.

Brooks Barristers & Solicitors would like to thank Larry K. Berdugo of Independent Financial Concepts Group Ltd. and Richard Dias and Ajay Kitchlu of Investors Group Financial Services Inc. for contributing the following two articles explaining the basics of life insurance and alternatives for funding buy-sell arrangements in shareholder agreements.

Risk-taking is a quality that most successful entrepreneurs possess. The classic proverb “*the greater the risk, the greater the reward*” is demonstrated in the attitude of many successful business owners. However, entrepreneurs should understand and appreciate the need to minimize risk when it comes to protecting their business and assets by investing in insurance.

Insurance is a vital asset in the portfolios of companies large and small. Insurance protects all aspects of a business from providing medical coverage for employees to the protection of tangible assets through property, liability and fire insurance.

We encourage you to review all personal and business insurance requirements and investigate a variety of different choices you and your company may be interested in. This newsletter will focus on life insurance especially when used in a corporate context to protect your interest in a company and the company’s ability to continue in the event that you cannot operate it.

Addressing your life insurance requirements can be a task that is consistently delayed because more immediate tasks require your attention or

because it is an unpleasant topic to think about. However, life insurance is an important product and understanding it and the options it provides allows you to make an informed decision about one of the most important purchases you can make for yourself, your company and your family.

1. LIFE INSURANCE—THE BASICS

During your life you generate an income that supports your dependents’ lifestyle. When your income is gone, life insurance takes over. The proceeds from your policy can be invested to replace your income and maintain your family’s lifestyle as it was when you were alive. Typically, insurance proceeds are tax-free and can be very useful in paying any taxes that may arise on your death.

There are two basic types of life insurance: *term* and *permanent*.

1. **Term Insurance** may be all the life insurance you ever need, or it may be an interim step before purchasing permanent insurance. It is well suited to meeting high, short-term protection needs for the lowest initial cost. For example, a couple with young children and/or a mortgage might select term insurance as an affordable way to obtain the full coverage they need today. Many term insurance plans do a good job of meeting immediate needs and provides a person with the freedom to later move or convert to a permanent life insurance plan without providing proof of health.

Many term plans are renewable after 5, 10 or 20 years without providing proof of health. The price will increase with your age at renewal, and the increase in premium can become substantial in later years. Coverage ceases for the majority of term contracts once you reach the age of 75 or 80.

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2. Permanent Insurance, as the name implies, provides lifetime coverage and comes in two main varieties: *whole life* and *universal life*.

(i) Participating (par) Whole life is the 'traditional' type of policy and usually the most expensive. A par whole life policy provides a guaranteed amount of insurance coverage for life and a guaranteed cash value. Inside the policy, a reserve account keeps premium costs level for life or in the case of some policies for a pre-set period of time. The cash value of the policy is a tax-deferred fund and can grow beyond the basic guaranteed values with the addition of dividends, which are generated and paid to policyholders if the company experiences a surplus. Surpluses are the result of investment returns, mortality and expense control being more favourable than anticipated.

There are several choices for the use of dividends - the most popular are either to buy additional permanent coverage each year or to buy a combination of term and permanent insurance, which can make a larger amount of coverage affordable. You generally have no control over how your money is invested - the insurance company directs the investment of policy funds - and you can recover the full cash value only if you cancel the policy. As a policyholder, you can borrow from the cash value but you will pay interest on the loan and death benefits are reduced unless loan is paid back. On the other hand, the cash value growth can give you additional options such as extended coverage or lower premium payments.

Whole life insurance is available with a term insurance component that enhances base coverage and can considerably reduce the overall cost.

(ii) Universal life currently accounts for the majority of permanent insurance purchased in Canada. Universal life insurance provides a combination of permanent life insurance and tax

advantaged investment options in one policy. As cash values accumulate, they can be used to pay part or all of the cost of your insurance or to increase the death benefit. You select an investment mix that is as individual as you are - taking into account the amount of investment risk you are comfortable with, and your financial goals and circumstances. This type of policy is generally for people who want to actively manage their life insurance policy.

Many people have both short and long term insurance needs and require varying amounts of coverage over different periods of time. A combination of permanent and term life insurance is usually the best solution and can be combined in one policy. Most permanent policies allow for the addition of low-cost term coverage without an additional policy fee. This provides a way to obtain the right amount of coverage at a more economical price, giving you a base of permanent coverage that won't increase in cost.

*The above article was provided by
Richard Dias & Ajay Kitchlu.*

2. LIFE INSURANCE—SHAREHOLDERS AGREEMENT FUNDING

Life insurance is often used by companies and individuals to fund various business buyouts and estate planning approaches. Insurance can prove to be the most cost effective approach to funding the untimely death of a partner/shareholder.

For many growing businesses each partner brings different yet equally valuable assets to the table. If one partner were to suddenly die or become disabled the growth of the business could be seriously jeopardized. There is also the need to "buy-out" the deceased partner's shares. But many business owners would find themselves in a cash crunch if they needed to

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raise substantial amounts of money under these circumstances.

That's where life and disability buy-out insurance can prove to be a valuable tool. The business would get a tax-free cash infusion at a time when it might need it the most. All for pennies on the dollar. The most common and least expensive type of life insurance is term insurance and it can easily satisfy the needs of most businesses.

Often overlooked, yet equally important, is disability buy-out insurance. This type of insurance would pay out a lump sum on the ongoing and extended disability of one of the partners. Some would argue that disability insurance buy-out is more important since there is a greater likelihood of disability before age of 65 than death.

There are essentially four methods to ensure an orderly transfer of ownership and that the surviving shareholder's family is cared for:

1. Criss-Cross Purchase Method
2. Promissory Note Method
3. Corporate Share Redemption
4. Hybrid Method

Each method has its own pros and cons and must be considered in light of the circumstances of a given case.

There are several additional issues to examine when considering the implementation of any of these methodologies and they include but are not limited to: tax considerations, the *Family Law Act*, policing of policy premiums, cost of premiums, ease of administration and creditor protection.

For the following examples, we will use shareholders A & B for illustrative purposes.

(1) Criss-Cross Purchase Method

Generally, a cross-purchase is the cleanest and easiest to administer. This method does not involve the corporation.

In this scenario, if shareholder A were to die, shareholder B is obligated under the terms of a shareholders agreement to purchase the shares from the estate of shareholder A at a pre-specified value. (We strongly recommend that, where a corporation is owned by more than one individual or entity, a shareholders agreement be put in place between the various owners.) The estate of shareholder A would be obligated to sell the shares of shareholder A to shareholder B. The most common and cost effective way to fund this type of agreement is through the use of life insurance.

In this situation, shareholders A and B would each personally own the policies on the other. This is the only method where the policies are personally-owned and not company-owned.

Life insurance premiums are generally not deductible for income tax purposes. If the corporation is in the same or lower tax bracket than the shareholders, the corporate owned policies might be more cost effective. However, other tax considerations should be examined.

There are also other issues relating to the *Family Law Act* as well as creditor-proofing status that might make this method more attractive.

(2) Promissory Note Method

Under this type of arrangement, shareholder A would agree to purchase shareholder B's shares on shareholder B's death, and shareholder B's estate would be under a corresponding obligation to sell the shares to shareholder A. Shareholder B would have a similar obligation to purchase shareholder A's shares on the latter's death. The corporation (which both shareholders own)

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would be the owner and beneficiary of the life insurance policies and would pay all premiums.

Upon the death of shareholder A for example, the following transactions would be stipulated in a shareholder's agreement:

1. Shareholder B would purchase shareholder A's shares from his estate using a promissory note.
2. The corporation would then be obligated under the agreement to use the life insurance proceeds received on shareholder A's death to pay a dividend to shareholder B. The corporation would elect to pay the dividend out of its capital dividend account.
3. Shareholder B would then use the dividend to retire the promissory note given on the purchase of shareholder A's shares.

It should be noted that shareholder A's shares are purchased by shareholder B prior to the corporation declaring the dividend. Otherwise, the estate of shareholder A would be entitled to a dividend on its shares. This in turn would mean that the surviving shareholder would not receive sufficient funds (in the form of a tax-free dividend) to retire the promissory note given on the purchase of the shares from the estate

This method may be favoured in situations where the \$500,000 capital gains exemption remains in tact for the particular shareholder (discussed later). This is because the deceased shareholder pays no tax on any gains realized on death in respect of his or her shares, and the surviving shareholder(s) are able to increase the cost basis of their shares by the amount paid to the deceased's estate.

The capital gains exemption is available only if the business is a considered a qualifying small business corporation. A small business corporation is defined as a Canadian Controlled Private Corporation (CCPC) if substantially all

(90% or more) its assets are used in an active business carried on in Canada.

However, whenever a promissory note method is considered, it is usually advantageous to consider a hybrid method, which combines elements of the promissory note method and the corporate redemption method. The hybrid method provides additional tax planning flexibility upon death of a shareholder.

(3) Corporate Share Redemption

This method obligates the corporation to repurchase or redeem the shares of a deceased shareholder.

The corporation would be the owner, premium payor and beneficiary of a life insurance policy on each shareholders life. If a shareholder dies, the corporation will use the proceeds of the policy to redeem the shares.

One issue to be determined up front when examining the tax consequences is whether or not the shares of a corporation are grandfathered under the stop-loss provisions of subsection 112(3) – (3.2) of the *Income Tax Act*.

The grandfathering provisions under the stop-loss provisions apply where a corporation had a shareholders agreement or life insurance policy in force prior to April 25, 1996. Without going into too much detail, it would be advantageous from a tax planning perspective to have had either one of these in place prior to that date.

The key here is that if the shareholders do in fact have a capital gains exemption available this is **not** the preferred method. On death of a shareholder the corporation would receive the insurance proceeds tax-free and would receive a credit to the notional Capital Dividend Account. The corporation would declare a dividend (not a capital dividend) and this dividend would be

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taxable to the estate thereby negating the benefit of the credit for buy/sell purposes.

(4) Hybrid Method

This method provides the most flexibility and is designed to minimize the tax liability of both the deceased shareholders and the surviving shareholder(s). Upon the death of a shareholder, the executor would determine the number of shares that are to be purchased by the surviving shareholder(s) using the promissory note method, with the remaining shares being redeemed by the corporation. The decision is typically based on the tax situation of deceased shareholder and the ability to shelter any capital gains by using the capital gains exemption or other unutilized losses. However, with the application of stop-loss provisions other considerations may play a part in the decision.

Once the determination is made, the estate of shareholder A is obligated to sell and shareholder B is obligated to purchase the specified number of shares based on the terms of the shareholders agreement. Shareholder B issues a promissory note as payment for the shares. For the remaining shares, the estate is obligated to sell and the corporation is obligated to purchase for cancellation (redeem) the shares.

Again in this instance, corporate owned life insurance would be the appropriate method. The corporation pays the premiums and is the beneficiary of the policy.

The income tax considerations in this scenario are a little more complex but could work out to be the most beneficial for all parties involved. The Stop-loss provision under subsections 112 (3) – (3.2) of the *Income Tax Act* will impact the transaction under the corporate redemption method (unless the shares are grandfathered).

The hybrid method provides the most flexibility to elect the appropriate buy-sell method at time

of death. The stop-loss provisions need to be addressed and the agreement should clearly state how the split between the promissory note and the corporate redemption method is to be determined.

*The above article was provided by **Larry K. Berdugo**.*

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