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Buy/Sell agreements – Crisscross method

A buy/sell agreement is an important part of financial planning for business owners, whether they're partners or shareholders. A buy/sell agreement simplifies the succession of the business. It ensures a buyer is available to purchase the business interest of a co-owner when a specific event occurs. It's advisable co-owners establish a buy/sell agreement specifying how an ownership interest of a co-owner will be transferred and what triggering events will give rise to the ability or obligation to transfer that ownership interest.

Funding a buy/sell agreement

Once the buy/sell agreement is established, the next step is to ensure funding is available to fulfill the obligation under the agreement. While there are different methods used to arrange funding, insurance is often the most cost-effective, simplest and safest method.

To arrange funding to meet the buy/sell obligation at death, a life insurance policy is purchased on the life of each co-owner. To fund the buy/sell obligation arising from a critical illness or disability of a co-owner, a critical illness or disability insurance policy is purchased.

The focus of this article is the buy/sell obligation at death, and as such, the discussion below applies to life insurance.

Structure of an insurance policy

Once it's decided to buy life insurance to fund the buy/sell obligation, the next consideration is to determine the structure (e.g., who is the owner, who pays the insurance premium, and who receives the death benefit). Generally, one of the following four types of buy/sell structures is used:

1. Crisscross method
2. Promissory note method
3. Share redemption method
4. Hybrid method, referring to a combination of #2 and #3

In this article, we discuss the crisscross method.

Crisscross method

This is the most basic form of buy/sell structure. Under this method, on the triggering event, the continuing co-owners are obligated to purchase the ownership interest of the deceased / critically ill / disabled co-owner, and the estate of the deceased co-owner or the critically ill / disabled co-owner is obligated to sell their ownership interest to the continuing co-owners.

Depending on when the obligation to buy the ownership interest arises under the buy/sell agreement, each co-owner purchases an insurance policy (life, critical illness, disability) on every other co-owner and becomes the beneficiary under that policy. Generally, the owner of the policy pays the premium with his/her after-tax dollars. On occurrence of the insured event, the insurer pays the insurance benefit to the beneficiaries (the other co-owners), who in turn use the insurance proceeds to buy the ownership interest from the estate of the deceased co-owner or the critically ill / disabled co-owner.

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The estate of the deceased co-owner or the critically ill / disabled co-owner either surrenders the insurance policies they own on the remaining co-owners, or sells/transfers these policies to the insured co-owners at fair market value.

The diagram at the end of this article illustrates this method. While it explains how the crisscross method works, it doesn't answer the question most business owners ask – what are the income tax implications?

What happens – from an income tax perspective

a) When insurance policies are bought

There are no income tax implications when the insurance policies are bought. However, the insurance premium is considered a personal expense, so each co-owner pays the premium using his/her after-tax dollars. If the premium is paid by the business, it could be considered a draw by a partner in the case of a partnership, and employee/ shareholder benefit or dividend in the case of a corporation.

b) When a triggering event occurs

At death of the insured co-owner, the deceased is deemed to have disposed of their assets at fair market value immediately before death. The ownership interest in the business is one of those assets. Based on the difference between the fair market value and adjusted cost base of the business interest, the deceased would realize either a capital gain or loss.

If the ownership interest is shares of a qualified small business corporation, the deceased may be able to claim the available portion of his/her lifetime capital gains exemption[1] to shelter some or all of the capital gains on the deemed disposition of the shares.

The estate of the deceased is deemed to have acquired the ownership interest at fair market value. Assuming the ownership interest is then immediately sold to the continuing co-owners, at the same price, the estate will not realize any additional capital gain or loss.

If the triggering event is critical illness or disability, the critically ill / disabled co-owner personally realizes either a capital gain or loss on sale of their ownership interest to the continuing owners. Again, if the ownership interest is qualified small business corporation shares, the seller may be able to claim the unused portion of his/her capital gains exemption.

c) When the insurance benefit is received

When the insured event occurs, the insurance benefit is paid to the beneficiary co-owners with no tax implication. The insurance benefit is then used by the continuing co-owners to pay the critically ill / disabled co-owner.

At purchase of the ownership interest by the continuing co-owners, their ownership interest increases and the adjusted cost base of their interest in the business is increased by the amount of the purchase price. The increase in the adjusted cost base reduces any future capital gain or increases a capital loss when the continuing co-owners sell their ownership interest.

Advantages of the crisscross method

- Simple and easy to implement

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[1] Maximum $892,218 for 2021, and indexed thereafter

- Provides continuing co-owners with the funds needed to fulfill their obligation under a buy/sell agreement
- Provides comfort the critically ill / disabled co-owner or their estate will receive the agreed value for their business interest
- Allows for the possibility to claim the capital gains exemption
- Provides for a step-up in adjusted cost base of the continuing co-owners interest

Disadvantages of the crisscross method

- It's administratively burdensome to implement if there are more than two co-owners. In this case, instead of each co-owner personally owning the insurance policies on every other co-owner, fewer policies would be needed if a trust were set-up to own the policies.
- It requires the use of after-tax money to pay the insurance premiums at the personal level. This may require greater pre-tax income, compared to the policies being owned by either holding companies or the operating company, if the corporate tax rate is lower than the personal rate.
- If age, health status and / or ownership percentage of the co-owners differ significantly, the premium cost incurred by each co-owner may not be fair or equitable.

When insurance policy is bought

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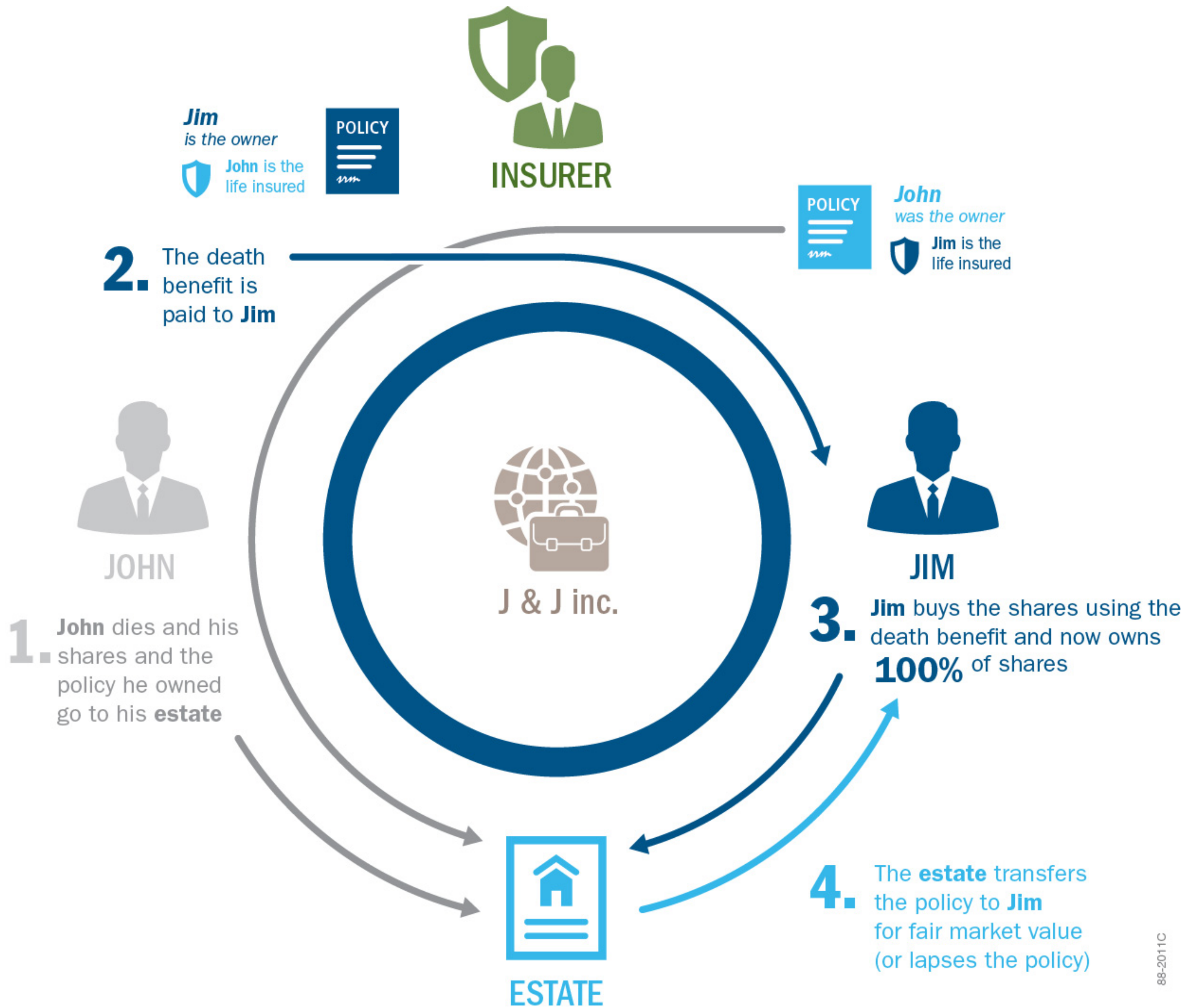
When one of the shareholders dies



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