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# Buy/Sell agreements – Hybrid 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 the 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 will discuss the hybrid method.

## Hybrid method

The hybrid method attempts to combine the benefits of both the promissory note and share redemption methods.

When a shareholder dies, the surviving shareholders are required to purchase a specified number of shares from the deceased shareholder's estate, using a promissory note as payment. The corporation also is required to redeem the remaining shares held by the deceased shareholder's estate.

The death benefit from a life insurance policy provides the funding for both transactions. In this case, the corporation owns a life insurance policy on the life of each shareholder. The corporation also pays the premiums and is the beneficiary.

When a shareholder dies, the corporation collects the insurance proceeds from the insurer. Typically, pursuant to the shareholder's agreement, the executor of the deceased's estate tells the surviving shareholders how many shares to purchase.

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The executor must consider factors such as:

- Amount of the deceased's unused and available lifetime capital gains exemption
- Any balance in the deceased's capital loss carry forward
- Adjusted cost base of shares
- Any capital loss from the deemed disposition of assets on death
- Impact of stop-loss rules on redemption of shares

The executor works with the deceased's tax advisors to determine the number of shares to be sold to the surviving shareholders and the number of shares to be redeemed.

A portion of the insurance proceeds is used to pay a dividend – preferably a tax-free capital dividend – to the surviving shareholders. This enables them to repay their promissory note to the estate.

If the surviving shareholders do not purchase all the estate's shares, then the corporation buys back, or redeems, the estate's remaining shares. To do this, it uses any remaining insurance proceeds.

If the corporation has received sufficient insurance proceeds, then the deemed dividend to the estate from this share redemption can be treated as a tax-free capital dividend.

## Income tax implications

### When insurance policies are purchased

There are no income tax implications to the corporation or shareholders when the insurance policies are purchased. However, because life insurance premiums are generally a non-deductible expense for tax purposes, the corporation pays the premium using after-tax dollars.

### When a death occurs

Taxpayers are deemed to have disposed of their capital assets at fair market value immediately before death. The ownership interest in the business (e.g., shares of the corporation) is one of those assets. Based on the difference between the fair market value and adjusted cost base of the shares, the deceased shareholder would realize either a capital gain or loss.

If the deceased's shares are qualified small business corporation shares, the executor of the deceased's estate may be able to claim the remaining portion of the deceased's lifetime capital gains exemption[1] to shelter some or all of the capital gains arising from the deemed disposition of the shares at death.

The estate of the deceased shareholder is also deemed to have acquired the deceased's shares at this same fair market value.

[1] The maximum exemption is $892,218 in 2021, indexed for inflation in later years.

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## When the life insurance death benefit is received

Upon death of the insured, the death benefit from an exempt life insurance policy is paid tax-free to the beneficiary (i.e. the corporation). Generally, in the case of a private corporation, the excess of the life insurance proceeds over the policy's adjusted cost basis is added to the corporation's capital dividend account.

The corporation can declare a tax-free capital dividend to shareholders who are residents of Canada for income tax purposes, to the extent a balance is available in the capital dividend account.

## When a portion of the estate's shares are bought and sold

Based on the decision of the executor of the deceased shareholder's estate, the surviving shareholders buy a specified number of shares from the estate using a promissory note. For tax implications of the promissory note method, refer to the buy/sell article on that method.

## When remaining shares are redeemed

After the surviving shareholders buy the specified numbers of shares, the corporation redeems the remaining shares held by the estate. For tax implications of the share redemption method, refer to the buy/sell article on that method.

# Advantages and disadvantages

The hybrid method combines the advantages of the promissory note and share redemption methods. The hybrid method also seeks to eliminate or reduce the impact of those methods' disadvantages; for example, the stop-loss rule. For advantages and disadvantages of the promissory note and share redemption methods, refer to the relevant buy/sell articles.

# Example

The following example helps illustrate the tax consequences of the hybrid method.

We will assume the following facts:

- John and Jim are residents of Canada and equal shareholders of J & J Inc., a private Canadian corporation.
- The adjusted cost base and paid-up capital of the shares owned by each of John and Jim are $100.
- The fair market value of J & J Inc. is $4,000,200.
- The shareholders' agreement provides for the buyout of a deceased shareholder's shares using the hybrid method, which is a combination of the promissory note and share redemption methods.
- The valuation formula provides the sale price of a deceased shareholder's shares. The formula excludes the death benefit the corporation receives as beneficiary of an insurance policy on the deceased shareholder's life.
- J & J Inc. purchased separate life insurance policies on John and Jim's lives with a death benefit of $2,000,000 for each policy. The adjusted cost basis of each policy at the time of death is nil.
- John and Jim's marginal tax rate is 50 per cent. Their capital gains tax rate is 25 per cent. Their estates have a 44 per cent marginal tax rate on non-eligible dividends.
- The unused balance of the lifetime capital gains exemption available to John is $800,000.

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- If John dies first, the sale and redemption of his shares produce different tax results, depending on whether John's shares are grandfathered.

If John's shares are not grandfathered, the results also depend on whether the full dividend is treated as a tax-free capital dividend or whether the 50 percent solution is used.

The tax results of each alternative are shown in the table that follows. For a discussion of grandfathering, stop-loss and the 50 percent solution, refer to the buy/sell article on the share redemption method.

## Conclusion

The buy/sell event may take place many years in the future, and the shareholders' tax situation may change over time. Using the hybrid method may be preferable because it provides the deceased and surviving shareholders with greater flexibility.

With the hybrid method, the buy/sell agreement can provide flexibility by:

- Permitting the executor to specify the number of shares to be bought by surviving shareholders
- Specifying the use of the capital dividend account for tax-free dividends
- Giving the surviving shareholders the ability to put forth a different buy/sell plan, if it does not negatively affect the after-tax result for the estate

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## Tax results of hybrid buy/sell example

| | If John's shares are grandfathered | If John's shares are not grandfathered | |
|---|---|---|---|
| | | If full dividend is a tax-free capital dividend | If using 50 percent solution* |
| **Terminal tax return of John** | | | |
| Deemed disposition | 2,000,100 | 2,000,100 | 2,000,100 |
| Less: Adjusted cost base | (100) | (100) | (100) |
| Capital gains | 2,000,000 | 2,000,000 | 2,000,000 |
| Less: Capital gains exemption | (800,000) | (800,000) | (800,000) |
| Remaining capital gain | 1,200,000 | 1,200,000 | 1,200,000 |
| Less: Capital loss carry back* | (1,200,000) | (600,020) | (1,200,000) |
| Net capital gain | - | 599,980 | - |
| Taxable capital gains (50%) | - | 299,990 | - |
| Tax rate | 50% | 50% | 50% |
| Tax payable | - | 149,995 | - |
| **Tax return of John's estate** | | | |
| Paid-up capital of shares | 100 | 100 | 100 |
| Paid-up capital of shares sold | 40 | 40 | 40 |
| Paid-up capital of shares redeemed | 60 | 60 | 60 |
| *When shares are sold* | | | |
| Proceeds of disposition | 800,000 | 800,000 | 800,000 |
| Less: Adjusted cost base | (800,000) | (800,000) | (800,000) |
| Capital gains | - | - | - |
| *When shares are redeemed* | | | |
| Proceeds of disposition | 1,200,100 | 1,200,100 | 1,200,100 |
| Less: Paid-up capital of shares redeemed | (60) | (60) | (60) |
| Deemed dividend on redemption | 1,200,040 | 1,200,040 | 1,200,040 |
| Less: Elected as capital dividend | (1,200,040) | (1,200,040) | (600,020) |
| Taxable dividend | - | - | 600,020 |
| Tax rate | 44% | 44% | 44% |
| Tax payable | - | - | 264,009 |
| Proceeds of disposition | 1,200,100 | 1,200,100 | 1,200,100 |
| Less: Deemed dividend on redemption | (1,200,040) | (1,200,040) | (1,200,040) |
| Adjusted proceeds of disposition | 60 | 60 | 60 |
| Less: Adjusted cost base | (1,200,100) | (1,200,100) | (1,200,100) |
| Capital loss | (1,200,040) | (1,200,040) | (1,200,040) |
| Less: Reduction due to stop-loss rule | - | 600,020 | - |
| Capital loss carried back* | (1,200,000) | (600,020) | (1,200,000) |

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| | If John’s shares are grandfathered | If John’s shares are not grandfathered | |
|---|---|---|---|
| | | If full dividend is a tax-free capital dividend | If using 50 percent solution* |
| Reduction due to stop-loss rule | | | |
| Lesser of: | | | |
| a) Capital dividend | N/A | 1,200,040 | 600,020 |
| b) Loss *less* taxable dividend | N/A | 1,200,040 | 600,020 |
| Less: 50% of lesser of | | | |
| c) Capital gain on deemed disposition | N/A | 2,000,000 | 2,000,000 |
| d) Capital loss of estate | N/A | 1,200,040 | 1,200,040 |
| Loss reduction | N/A | 600,020 | - |
| | | | |
| **Tax payable by John and his estate** | | | |
| John | - | 149,995 | - |
| Estate | - | - | 264,009 |
| Total | - | 149,995 | 264,009 |
| | | | |
| **Remaining capital dividend account in J & J Inc.** | | | |
| Capital dividend account from death benefit | 2,000,000 | 2,000,000 | 2,000,000 |
| Capital dividend account used | | | |
| – to remaining shareholder | (799,960) | (799,960) | (799,960) |
| – deemed dividend | (1,200,040) | (1,200,040) | (600,020) |
| Remaining capital dividend account | - | - | 600,020 |
| | | | |
| **Jim's adjusted cost base after buy/sell** | | | |
| Adjusted cost base of original shares | 100 | 100 | 100 |
| Adjusted cost base of new shares | 800,000 | 800,000 | 800,000 |
| New adjusted cost base | 800,100 | 800,100 | 800,100 |

* Effective from 2016, to be eligible for loss carry back and 50 percent solution, the estate must qualify as a graduated rate estate. This is a testamentary trust that arises on and as a consequence of the taxpayer’s death. Only one estate may qualify as a graduated rate estate, for no longer than 36 months after the death.

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## When insurance policy is bought

When one of the shareholders dies