Buy/Sell agreements – Promissory note 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 is 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 promissory note method.

Promissory note method

Under this method, upon the death of a shareholder, the surviving shareholders are obligated to purchase the shares of the deceased shareholder, and the deceased's surviving spouse/common-law partner or estate is obligated to sell the shares to the surviving shareholder(s).

To arrange the funding for the buy/sell agreement, each shareholder is insured separately and each policy is corporately owned. This means the corporation pays the premiums and is the beneficiary.

In the event a shareholder dies, the surviving shareholder(s) purchase the shares of the deceased shareholder from the surviving spouse/common-law partner or estate and pay for the shares using a promissory note to the seller.

Once the purchase and sale transaction is complete, the corporation collects the insurance proceeds from the insurer. The death benefit from an exempt life insurance policy is paid tax-free to the corporation (beneficiary). In the case of a

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private corporation, the excess of the life insurance proceeds over the adjusted cost basis of the policy is added to its capital dividend account.

A tax-free capital dividend can be declared by the corporation to its shareholder(s) (who are residents of Canada for income tax purposes) to the extent a balance is available in the capital dividend account.

Once the life insurance proceeds are received by the corporation, it is then paid to the surviving shareholder(s) as a dividend. This dividend is designated as a tax-free capital dividend to the extent possible, based on the balance in capital dividend account.

The surviving shareholder(s) use the money from the corporation's dividend to repay the promissory note.

It is important that the buy/sell transaction is completed before any dividend is declared and paid to any shareholders. Otherwise, the deceased shareholder's surviving spouse/common-law partner or estate would still be a shareholder, and as all the shareholders of the same class of shares have to be treated equally when dividends are paid, the surviving spouse/common-law partner or estate would also be entitled to share in the dividend. This would reduce the amount of dividends paid to the surviving shareholder(s), and in turn the amount available to the surviving shareholder(s) to repay the promissory note.

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, since the insurance premium is generally considered 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 assets at fair market value immediately before death, unless they leave their assets to a surviving spouse/common-law partner on a tax-deferred rollover basis. The ownership interest in the business (i.e., 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 that would be reported in his or her terminal tax return.

If the shares are of a qualified small business corporation (QSBC shares), the deceased may be able to claim the available portion of their lifetime capital gains exemption[1] to shelter some or all of the capital gain realized by the deemed disposition of the shares.

However, if the shares are rolled over to the spouse or common-law partner on a tax-deferred basis, the deceased will not realize any gain or loss. In this case, any gain or loss will be deferred until the earlier of the spouse or common-law partner: i) sells the shares, or ii) dies.

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

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When shares are bought and sold

a) Shares transferred to estate

Since the deceased shareholder is deemed to dispose of his or her shares at fair market value, the estate of the deceased is also deemed to have acquired the shares at the same fair market value -- this is now the adjusted cost base of the shares to the estate. Assuming the estate's ownership interest is then immediately sold at fair market value to the continuing shareholders, the estate will not realize any additional capital gain or loss.

b) Shares rolled over to spouse or common-law partner

If the deceased's shares are rolled over, the adjusted cost base of the deceased in the shares becomes the adjusted cost base of the shares to the surviving spouse or common-law partner.

When the spouse or common-law partner sells the shares to continuing shareholders he or she would realize any capital gain or loss.

If the shares are QSBC shares, the surviving spouse or common-law partner might also be able to claim the available portion of his or her lifetime capital gains exemption to shelter some or all of the capital gains on sale of shares to continuing shareholders.

The purchase of the shares from the estate/spouse or common-law partner will increase the ownership interest of the surviving shareholder(s). The purchase price paid will increase the adjusted cost base of the remaining shareholder's shares. This increase in the adjusted cost base will reduce any future capital gain or increase any future capital loss when the continuing shareholder(s) sell their ownership interest.

When the insurance benefit is received

Upon the death of the insured, the death benefit from an exempt life insurance policy is paid tax-free to the beneficiary corporation. In the case of a private corporation, the excess of the life insurance proceeds over the adjusted cost basis of the policy is added to its capital dividend account.

A tax-free capital dividend can be declared by the corporation to its shareholder(s) to the extent a positive balance is available in the capital dividend account.

When a capital dividend is paid

Generally, dividends paid by a corporation are taxable income to the recipient shareholder(s).

When the dividend is designated by the corporation as a capital dividend, and the recipient shareholder(s) are residents of Canada for tax purposes, the shareholder(s) do not pay tax on this dividend.

When the promissory note is discharged

Repayment of the promissory note does not result in any tax consequences. If any interest is paid, it is considered investment income to the recipient, and potentially an investment related expense for the payor that may be deductible for tax purposes.

Advantages of the promissory note method

- It is simple and easy to implement, especially when there are multiple shareholders.

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- Life insurance on each shareholder provides the continuing shareholders with the funds needed to fulfill their obligations under a buy/sell agreement.
- It provides comfort to the shareholders that a deceased shareholder's estate will receive the agreed value for the shares.
- It provides opportunity for the deceased shareholder's representative to claim the deceased shareholder's lifetime capital gains exemption.
- It provides for a step-up in the adjusted cost base of the surviving shareholder(s) shares.
- The corporation paying the premiums provides a reasonable cost-sharing method.
  - The cost is effectively shared by the shareholders based on their proportionate interest in the corporation.
- Since the corporation is the beneficiary, there is generally no shareholder benefit on payment of premiums by the corporation.
- If the corporation is eligible for the small business deduction, the before tax income required to pay the premiums may likely be less than if the shareholders owned the insurance and paid the premiums personally.

Disadvantages of the promissory note method

- The death benefit received by the corporation may be exposed to the claims of its creditors.
- The corporation may be subject to restrictions on the amount it can distribute as dividends under the governing corporate law or imposed by creditor covenants.
- Share sales proceeds are not immediately received by the estate. Depending upon the delay in collection and distribution of the insurance proceeds, the estate may face a temporary delay or shortfall in paying the taxes and other liabilities of the deceased. However, a loan from the corporation to the estate may be arranged until the capital dividend can be declared and paid to the remaining shareholder(s). Once the remaining shareholder(s) receives the capital dividend money and repay the promissory note to the estate, the estate can then repay the loan to the corporation.
- If the corporation has previously realized capital gains, declared a capital dividend, and subsequently has capital losses, the entire death benefit less the adjusted cost basis of the policy may not be able to be distributed tax-free to the remaining shareholders. A tax accountant should track the complete history of transactions affecting the corporation's capital dividend account.

Example

An example will help us show the tax consequences

Assumptions

- John and Jim are residents of Canada and equal shareholders of J & J Inc., a qualified small business corporation.
- The adjusted cost base and paid-up capital of the shares owned by both John and Jim are $100 each.
- The fair market value of J & J Inc. is $4,000,200.
- The shareholders agreement provides for the buy-out of the shares owned by a deceased shareholder using the promissory note method. The valuation formula provides for valuing the shares without considering the death benefit of the life insurance policy that the corporation as beneficiary will receive.

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- J & J Inc. has purchased life insurance policies on each of John and Jim with a death benefit of $2,000,000 for each policy. The adjusted cost basis of the policy at the time of death is nil.
- John and Jim's marginal tax rate (MTR) is 50 per cent, (25 per cent for capital gains), and their respective estate will have a 44 per cent marginal tax rate on non-eligible dividends.
- Both John and Jim have not used their lifetime capital gains exemption.

If John were to die

On John's death, the shares will get transferred to his estate at fair market value or rolled over to his spouse at the shares adjusted cost base. The tax result as shown in John's terminal return will be as follows.

Terminal tax return for John

If no spousal rollover

FMV of J & J Inc. shares deemed disposed of on death		$2,000,100
Adjusted cost base of shares		$ 100

Capital gain		$2,000,000
Lifetime capital gains exemption		$ 892,218

Net capital gain		$1,107,782

Taxable capital gain	(1/2 of capital gain)	$ 553,891
MTR		50%

Tax payable		$ 276,945
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The adjusted cost base of the shares for the estate will be the shares fair market value of $2,000,100.

If spousal rollover

Proceeds of sale	$ 100
Adjusted cost base	$ 100

Gain or loss	$ Nil
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The adjusted cost base of the shares for the spouse or common-law partner will be $100.

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Jim will buy the shares from the estate or spouse in consideration for a promissory note of $2,000,100. After the purchase of shares Jim will be the sole shareholder of J & J Inc. The tax calculation on this sale of the shares will be as follows:

If shares were transferred to the estate (no rollover)

Proceeds of sale	$ 2,000,100
Adjusted cost base	$ 2,000,100

Capital gain or loss	Nil
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If the shares were rolled over to the spouse

Proceeds of sale	$ 2,000,100
Adjusted cost base	$ 100

Capital gain	$ 2,000,000
Spouse's lifetime capital gains exemption	$ 892,218

Net capital gain	$ 1,107,782

Taxable capital gain (1/2 of capital gain)	$ 553,891
MTR (assumes the spouse's MTR is the same as John's)	50%

Tax payable	$ 276,945
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J & J Inc. will collect the death benefit of $2,000,000. As the adjusted cost basis of the policy is nil, the entire death benefit is credited to the capital dividend account of J & J Inc.

J & J Inc. will then declare a dividend of $2,000,100 and designate $2,000,000 of it as tax-free capital dividend. The remaining $100 could be paid out as a taxable dividend, or alternatively as a tax-free return of paid-up capital. Jim being the sole shareholder will receive the dividend and use the $2,000,100 to discharge the promissory note.

The above example is for illustrative purposes only. Situations will vary according to specific circumstances.

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When insurance policy is bought

When one of the shareholders dies