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Partnership buy/sell agreements

Life insurance is commonly used to fund a buy-out of a deceased partner's interest in a partnership. This article focuses on common strategies using life insurance for funding the buy/sell provisions of a partnership agreement.

An overview of partnerships

Partnerships (*contract of partnership in Quebec*) are governed by provincial legislation and are generally described as a legal relationship existing between two or more persons (partners) carrying on a business in common with a view to profit. Unlike a corporation, a partnership is not a separate taxpayer under Canadian tax law. For tax purposes, income earned, or losses realized by the partnership are allocated to the partners based on the partnership agreement. The allocated income or loss is taxable at the partner level and is reported on the partner's tax return.

A partnership does not have a legal existence separate and apart from its partners. As a result, they do not generally provide the same level of creditor protection as a corporation. Partners may be personally liable for the obligations of the partnership. For example, assets of the partner may be seized by creditors to satisfy obligations which arise from the partnership's business[i].

Normally a partnership agreement is established between the partners to set out the rights, obligations, and responsibilities of the partners[ii]. Similar to a shareholders' agreement, a partnership agreement can be relied upon by the partners to avoid disputes and settle issues. Moreover, to ensure the partnership continues after the death or insolvency of one of the partners, the agreement must provide for the continuance of the partnership[iii]. The agreement will also address the buy/sell of a partner's interest in the event of their death.

A partnership can have a combination of individual or corporate partners. Traditionally partnerships were mostly made up of individual partners who collectively agreed to carry on a business. However, over the years it has become common to use corporate partners for various reasons including creditor protection, income splitting, estate planning and tax deferral[iv].

Funding the partnership agreement

Once the partnership agreement is established it is vital to ensure funding is available to fulfill the obligation under the agreement in the event of a partner's death. While there are different methods used to arrange funding, life insurance is often the most cost-effective, simplest, and most secure method. The focus of the remainder of this article is on the buy/sell obligation at death using life insurance.

Death of a partner

Before discussing the common buy/sell strategies available for partnerships we will provide a brief overview of the tax implications to a partner upon their death.

Individual partner

Upon the death of an individual partner they are deemed to have disposed of their partnership interest immediately prior to death for proceeds equal to its fair market value ("FMV")[v]. A capital gain will result to the extent the FMV of the partnership interest exceeds its adjusted cost base ("ACB") [vi]. The capital gain is reportable on the partner's terminal tax return. The deceased partner's estate is deemed to have acquired the partnership interest at this same FMV[vii]. As such the ACB of the partnership interest to the estate will equal the FMV at death.

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Corporate partner

Upon the death of a shareholder of a corporate partner, the shareholder is deemed to have disposed of their shares in the corporation immediately prior to death for proceeds equal to FMV . Assuming there is no spousal rollover, a capital gain will result to the extent the FMV of the shares exceeds its ACB. The capital gain is reportable on the deceased's terminal tax return. The deceased's estate is deemed to have acquired the shares at this same FMV which becomes the ACB of the shares to the estate.

Despite the death of the shareholder, the corporate partner continues to exist and therefore there is no immediate disposition (deemed or otherwise) of the partnership interest. As a result, the ACB of the partnership interest is not bumped up to FMV upon the death of the shareholder.

Partnership buy/sell strategies using life insurance

There are various ways for a partnership to structure the buy/sell in respect to a partner's death. We will outline some of the common strategies below.

Partnership with individual partners

In a partnership with individual partners there are two main strategies available to structure the buy/sell with life insurance. One approach is for the individual partners to own the life insurance policies and the second is where the partnership owns the policies.

a) Partner ownership of life insurance

In this structure the life insurance policies to be used for the buy/sell are owned and funded by the individual partners. In particular, each partner is the owner and beneficiary of life insurance on the lives of each of the other partners. For example, in a simple situation where there are two partners each partner would own and be the beneficiary of a life insurance policy on the life of the other partner.

Upon the death of a partner, the deceased is deemed to dispose of their partnership interest at FMV immediately before death (assuming no spousal rollover). To the extent this FMV exceeds the ACB of the partnership interest, the deceased partner will have a capital gain to report on their terminal return.

The surviving partner(s) would receive the life insurance proceeds from the policy on the deceased partner. The proceeds are tax-free to the surviving partner(s). These proceeds would be then used by the surviving partner(s) to purchase the partnership interest from the deceased partner's estate. Assuming the buy-out of the partnership interest occurs soon after death, and that the purchase price is equal to the FMV on death, the estate should not realize a capital gain on the sale. If the purchase price is higher than the FMV on death, the estate will realize a capital gain. The surviving partner(s) would get an increase in the ACB of their partnership interest equal to the purchase price.

A trust may sometimes be used in this type of buy-out structure to own the life insurance policies. This simplifies the structure when there are more than two partners. It also ensures premiums are paid and the policies are kept in force. Under this structure, normally the trust is the owner and beneficiary of all the policies, and the partners are the beneficiaries of the trust. Upon the death of a partner, the life insurance proceeds are paid tax-free to the trust and then flow out to the surviving partners so that they can acquire the partnership interest from the deceased partner's estate. The tax implications are the same as noted above.

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b) Partnership ownership of life insurance

In another common structure, the life insurance policies to be used for the buy/sell are owned and funded by the partnership. The partnership is also the beneficiary of the policies. The partnership agreement would specify that life insurance proceeds received by the partnership on the death of a partner will be used by the partnership to purchase the partnership interest from the deceased's estate[viii].

Upon the death of a partner, the deceased is deemed to dispose of their partnership interest at FMV immediately before death (assuming no spousal rollover). To the extent this FMV exceeds the ACB of the partnership interest, the deceased partner will have a capital gain to report on their terminal return.

The partnership would receive the life insurance proceeds from the policy on the life of the deceased partner. The proceeds are tax-free to the partnership. These proceeds are used by the partnership to purchase the partnership interest from the deceased's estate as stipulated in the partnership agreement. Assuming the buy-out of the partnership interest occurs soon after death, and that the purchase price is equal to the FMV on death, the estate should not realize a capital gain on the sale. If the purchase price is higher than the FMV on death, the estate will realize a capital gain. The surviving partner(s) would get no increase in the ACB of their partnership interest as the buy-out was at the partnership level.

Alternatively, instead of the partnership purchasing the deceased partner's interest, the life insurance proceeds could be allocated to the surviving partners[ix]. Assuming that the adjusted cost basis of the life insurance policy immediately before death is zero, the surviving partners could receive the proceeds tax-free from the partnership. The surviving partners could then utilize these proceeds to purchase the partnership interest from the estate. This alternative will give the surviving partners an increase in the ACB of their partnership interest. The tax implications to the deceased partner and their estate are the same.

Partnership with corporate partners

In a partnership with corporate partners[x] there are also two main strategies available to structure the buy/sell with life insurance. One approach is for the corporate partners to own the life insurance policies and the second is where the partnership owns the policies.

a) Partner ownership of life insurance

The life insurance policies to be used for the buy/sell could be owned and funded by the corporate partners. Each corporate partner could be the owner and beneficiary of life insurance on the lives of each of the sole shareholders of the other corporate partners. For example, in a simple situation where there are two corporate partners (i.e. corporate partner A owned by shareholder A and corporate partner B owned by shareholder B) each would own and be the beneficiary of a life insurance policy on the life of the shareholder of the other partner (i.e. corporate partner A would own a policy on the life of shareholder B and vice versa).

Upon the death of the shareholder of a corporate partner, the deceased is deemed to dispose of their shares in the corporate partner at FMV immediately before death (assuming no spousal rollover). To the extent this FMV exceeds the ACB of the shares, the deceased will have a capital gain to report on their terminal return. The corporate partner continues to exist and therefore there is no immediate disposition (deemed or otherwise) of the partnership interest.

The other corporate partner(s) would receive the life insurance proceeds from the policy on the life of the deceased shareholder. The proceeds are tax-free to the other corporate partner(s). These proceeds would be then used by the other corporate partner(s) to purchase the partnership interest from the deceased's corporation (i.e. corporate partner). A capital gain will likely be realized by the deceased's corporation to the extent the purchase price is greater than the ACB of the partnership interest (as the ACB of the partnership interest was not bumped to FMV upon death). The other

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corporate partner(s) would get an increase in the ACB of their partnership interest equal to the purchase price. Furthermore, the other corporate partner(s) will get a credit to their capital dividend account ("CDA") for the difference between the life insurance proceeds received and the adjusted cost basis of the policy immediately prior to death.

The above structure is not favorable to the deceased as there is a capital gain on the deemed disposition of their corporate shares on death, and there is further capital gain to their corporation upon the sale of the partnership interest to the other corporate partners.

Alternatively, a trust could be used in this type of buy-out structure to own the life insurance policies. This would simplify the structure when there are multiple partners, for example, when there are three or more partners. It will also ensure premiums are being paid and the policies are being kept in force. The tax implications to the deceased shareholder and their corporation are the same as above[xi].

b) Partnership ownership of life insurance

A more favorable structure from a tax perspective is for the life insurance policies to be owned and funded by the partnership. The partnership would also be the beneficiary of the policies. The partnership agreement would specify that life insurance proceeds received by the partnership on the death of the sole shareholder of a corporate partner will be used by the partnership to purchase the partnership interest from the deceased's corporation[xii].

Upon the death of a shareholder, the deceased is deemed to dispose of their shares in their corporation (corporate partner) at FMV immediately before death (assuming no spousal rollover). To the extent this FMV exceeds the ACB of the shares, the deceased will have a capital gain to report on their terminal return. The corporate partner continues to exist and therefore there is no immediate disposition (deemed or otherwise) of the partnership interest. As a result, the ACB of the partnership interest is not bumped up to FMV upon the death of the shareholder.

The partnership would receive the life insurance proceeds as beneficiary of the policy. The proceeds are tax-free to the partnership. These proceeds could then be allocated to the deceased's corporation in satisfaction of the partnership interest. In particular, the insurance proceeds net of the adjusted cost basis of the policy (immediately before death) can be allocated to the deceased's corporation pursuant to subsection 53(1)(e)(iii) of the Act. This will increase the ACB of the partnership interest owned by the corporation by an equal amount. Assuming the adjusted cost basis of the policy is nil, then the allocation by the partnership of the insurance proceeds should be tax-free to the deceased's corporation, resulting in no capital gain. Moreover, the deceased's corporation will receive a CDA credit which will allow the proceeds to be flowed out to the deceased's estate. However, other corporate partner(s) would get no increase in the ACB of their partnership interest as the buy-out was at the partnership level.

Alternatively, instead of the partnership purchasing the partnership interest, the life insurance proceeds could be allocated to the other corporate partners pursuant to subsection 53(1)(e)(iii) of the Act. Assuming that the adjusted cost basis of the life insurance policy immediately before death is zero, the other corporate partners could receive the proceeds tax-free from the partnership. The other corporate partners could then utilize these proceeds to purchase the partnership interest from the deceased's corporation. This alternative will give the others corporate partners an increase in the ACB of their partnership interest and a CDA credit. However, the deceased's corporation will likely realize a capital gain on the sale of the partnership interest as the ACB was not bumped up to FMV on death. As a result, this alternative isn't tax efficient for the deceased partner.

Conclusion

Although not as common as corporations, partnerships are sometimes used as a business structure in Canada. Most partnership agreements will have a buy/sell provision that deals with the death of a partner. Life insurance is often the

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least expensive method of funding this buy/sell obligation. This article has summarized the most common strategies of structuring the buy/sell obligation using life insurance.

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[i] An exception is a limited liability partnership ("LLP"). An LLP is commonly used for accounting and law firms to limit a partner's liability from claims. For example, if an LLP is sued by a client for negligence it is only the partnership assets and the personal assets of the partner involved with the client that are legally exposed (i.e. partners not involved with the specific client are not personally liable).
[ii] In the absence of a partnership agreement, provincial legislation will apply.
[iii] In the absence of this provision in the partnership agreement, generally provincial partnership law considers the partnership dissolved upon the death or insolvency of a partner.
[iv] Finance has taken measures to reduce these benefits recently by eliminating the multiplication of the small business deduction amongst corporate partners, reducing income splitting opportunities with the tax on split income rules and introducing the passive income rules.
[v] A partnership interest is capital property for tax purposes. Subsection 70(5) of the *Income Tax Act* ("Act") deems capital property of a deceased person to be disposed of immediately before death for proceeds equal to FMV at the time.
[vi] For purposes of this article we have assumed that the spousal rollover in subsection 70(6) of the Act does not apply. Subsection 70(6) provides for a tax-free rollover, such that the deemed disposition of capital property on death is deferred where the ownership of the property is transferred to a spouse, common-law partner, or a spousal trust.
[vii] Most often, a partnership agreement provides that the beneficiaries of a deceased partner are not permitted to acquire a partnership interest. As such, the deceased partner's estate is technically deemed to have acquired a "right to receive partnership property" pursuant to subsection 100(3) of the Act instead of the partnership interest. The tax implications are generally the same whether the estate is deemed to acquire the partnership interest or "a right to receive partnership property". For purposes of this article we have assumed the deceased partner's estate will acquire a partnership interest.
[viii] It is assumed that the partnership agreement states that the amount paid to the deceased partner's estate is in satisfaction of the purchase price for the deceased's partnership interest. As such the payment is considered a capital payment to the estate.
[ix] Assuming the partnership agreement allows for it, the life insurance proceeds received by the partnership can be allocated to the surviving partners (or corporate partners). Pursuant to subparagraph 53(1)(e)(iii) of the Act, the life insurance proceeds net of the adjusted cost basis of the policy can be added to the ACB of the surviving partners' (or corporate partners') partnership interest. In particular, the net insurance proceeds attributable to each surviving partner (or corporate partner) will increase the ACB of each partner's partnership interest. This increased ACB will allow the surviving partners (or corporate partners) to receive capital from the partnership without tax. It should be noted Canada Revenue Agency has taken the position that the life insurance proceeds (net of the adjusted cost basis of the policy) can only be allocated to the surviving partners (or corporate partners). As such, the net proceeds cannot be used to increase the ACB of the deceased's partnership interest.
[x] For the purposes of this article we have assumed that each corporate partner has a sole shareholder.
[xi] It is common for the trust to be owner and beneficiary of the life insurance policies and for the corporate partner(s) to be beneficiaries of the trust. On death of a shareholder, the death benefit is paid tax-free to the trust and can be distributed tax-free to the other corporate partners. However, the other corporate partners do not get a credit to their capital dividend account.
[xii] It is assumed that the partnership agreement states that the amount paid to the deceased's corporation (corporate partner) is in satisfaction of the purchase price for the partnership interest. As such the payment is considered a capital payment to the corporation.

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