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WEALTH MANAGEMENT

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> The Role of Insurance in Wealth Planning

Insurance solutions for funding a buy-sell agreement

ASSANTE ESTATE AND INSURANCE SERVICES INC.

Insurance solutions for funding a buy-sell agreement

The future of your business depends on all co-owners making the same contributions going forward as they make today. The risk is that health or personal issues may arise that prevent such contributions and threaten the success of your business. Fortunately, it's a risk you can manage through proper planning today.

Have you protected your business against the departure of a co-owner?

When your business is operating smoothly and successfully, it's easy to assume that you and your co-owners will continue to manage the company well into the future. However, every year across Canada, hundreds of companies must contend with the unexpected crisis of losing the services of a co-owner.

The most common situations resulting in the departure of a co-owner include:

> Co-owner suffers a long-term disability
> Co-owner becomes critically ill
> Premature death of a co-owner
> Divorce of co-owner where spouse becomes entitled to business interest
> Personal insolvency of a co-owner
> Any illegal actions by a co-owner
> Unresolved dispute with other co-owners
> Co-owner decides to retire

If your business loses one of its owners, the remaining co-owners must determine how the business will continue. This decision is best made well ahead of time, through a buy-sell agreement.

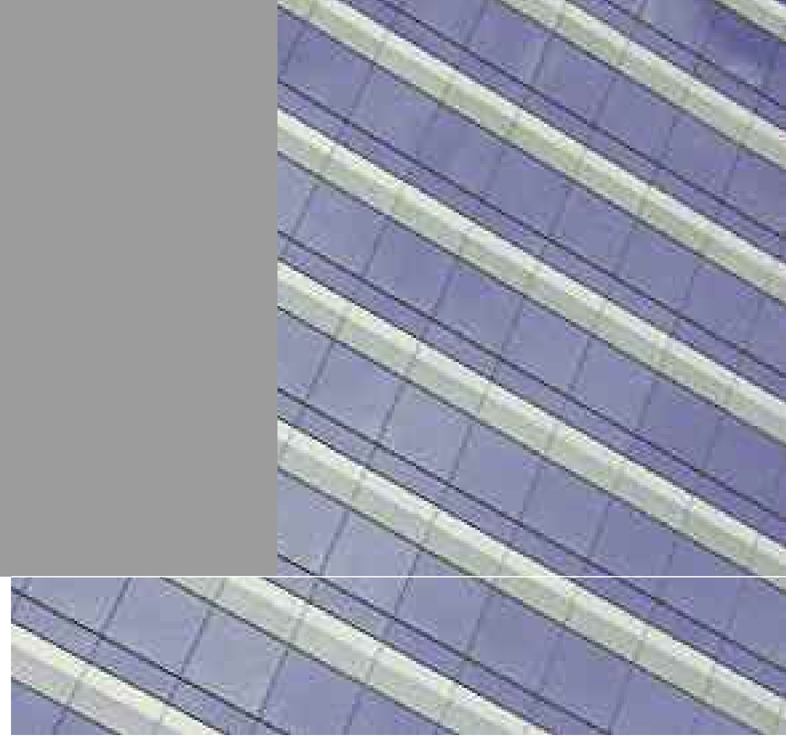
How a buy-sell agreement protects your business

A buy-sell agreement can either be a separate agreement or part of an overall shareholder's agreement. Its purpose is to protect the future of your business from the consequences of losing a co-owner. The agreement covers your choice of the common situations resulting in the departure of a co-owner. Quite often, death, disability and critical illness are considered essential situations to protect against.

Under the agreement, the remaining co-owner or co-owners will purchase the business interest of the departing co-owner. In the case of death, this usually means the business interest is purchased from the deceased co-owner's heirs. Note that this arrangement also benefits the heirs, as they are guaranteed an immediate buyer for their shares. In the case of all other covered situations resulting in the departure of a co-owner, the business interest is purchased from the departing co-owner.

The agreement usually includes a formula or outlines a process for valuing the business at the time of the buy-out.

With a buy-sell agreement, the business is guaranteed to stay in the hands of the remaining co-owners.



Why a buy-sell agreement is essential

If you do not have a buy-sell agreement at present, consider the consequences in the event that a co-owner passes away prematurely. The co-owner's business interest will pass to one or more of the person's heirs, quite often the spouse.

The remaining business owner or owners would then have five options:

> **Keep the heirs in the business:** This arrangement carries the risk of heirs having new ideas about operating the business that conflict with those of the other co-owners.

> **Take on an outside buyer:** First of all, finding an outside buyer for a closely held business is difficult, and you also run the risk of taking on a co-owner whose business vision ends up conflicting with that of the original co-owners.

> **Sell to heirs:** This option does occur, but many factors must fall perfectly into place: current owners must have reason to sell, heirs must be qualified to run the business, and heirs must have enough capital to acquire all co-owners' business interest.

> **Sell or liquidate the business:** Most often this option is a last resort. Selling the business to a third party can result in realizing considerably less than the company's genuine value, and liquidation proceeds can be largely absorbed by tax and other estate costs.

> **Buy out the heirs:** In the vast majority of cases, buying out the heirs is the most desirable option. This way, the remaining co-owners are free to operate the business as they have been doing successfully for years.

Of course the preferred method in most cases is the final option – buying out the heirs. But to make that option a possibility you must put together an agreed-upon plan, which is the buy-sell agreement. Otherwise, you could find yourself entertaining one of the less desirable options.

Funding the buy-sell agreement

The buy-sell agreement sets out the conditions for buying the business interests of another co-owner; funding the agreement provides the financial resources to make it all happen.

Funding the buy-sell agreement with life insurance

In the event that a co-owner passes away prematurely, life insurance is commonly the funding instrument of choice to purchase the deceased co-owner's business interest. To fully appreciate the reasons for this, it's helpful to examine the alternatives for purchasing a deceased co-owner's shares:

> **Accumulated savings:** With this strategy, after-tax capital is regularly invested in a vehicle earning taxable income. The problem is that the large sums of money required may not always be available, and when they are available, owners may prefer to put that money to work in growing the business.

> **Borrowing funds:** Borrowing from a bank may seem attractive, but it's not tax-efficient. The borrowed funds must be repaid with after-tax dollars, and the interest won't necessarily be tax-deductible. In addition, borrowing may be problematic if the departure of a co-owner makes the business less creditworthy.

> **Using a promissory note:** A promissory note can be issued to unconditionally promise to pay for the deceased owner's shares. However, when the time comes, this arrangement may not be viable for the estate if immediate cash is required. Also, the note must be paid with after-tax dollars.

> **Using business earnings:** Co-owners can receive business earnings which they use to fund the purchase, but this method relies on the company being in a solid cash position at the particular time. And even if the timing is ideal, it will deprive the business of capital and potentially limit growth.

> **Selling business assets:** When the timing of selling assets is based on the departure of a co-owner and not on market conditions, you run the risk of receiving less than full value. Of course, the business is also hit by loss of yield on assets sold.

> **Advantages of using life insurance:** When you use life insurance to fund a buy-sell agreement, you avoid the major pitfalls of the alternative methods outlined above, and gain several unique advantages as well:

- *Life insurance is cost-effective, with annual premiums costing a very small fraction of the purchase price of the co-owner's shares for each year the buy-sell agreement is in place.*
- *Since the insurance proceeds are paid upon a co-owner's death, cash is guaranteed to be available when needed.*
- *You gain tax advantages with life insurance, as certain policies allow you to benefit from a tax-sheltered savings component, and all policies pay insurance proceeds tax-free.*
- *Life insurance is a flexible vehicle, and policies can be customized to meet the unique needs of your buy-sell agreement.*

Funding the buy-sell agreement with disability insurance

Most business people don't think twice about using a buy-sell agreement to protect against the premature death of a co-owner. However, protection against a co-owner becoming disabled can be equally important.

A disability is an illness or injury that prevents you from working for an extended period. Some of the more common disabilities involve accidents resulting in serious injuries, psychological illnesses, stroke, heart disease, and musculoskeletal conditions such as back problems.

Consider these facts*:

> During our working years the odds of becoming disabled are eight times higher than the chances of dying.
> About half of all Canadians will suffer a disability during their working years.
> The majority of these disabilities last for an average of almost three years.
> Most important, you must consider that individuals who rejoin the workforce following a disability cannot always work in the same position they held before the disability.

**Commissioner's IDA Morbidity and Commissioner's SO Mortality Tables, Society of Actuaries; and CIA 86-92 Aggregate Mortality Table.*

Imagine the consequences of losing the services of one co-owner for several years. If that person has solid client relationships, you could potentially lose one or more clients. If the co-owner has strong ties with certain employees, you could lose staff. And certainly, productivity and revenue will suffer.

With a buy-sell agreement covering disabilities, and funded with disability insurance, the healthy co-owners buy out the disabled co-owner. Most policies allow you to choose a buy-out that occurs after the first year of the disability, or up to three years after the disability began.

The disabled co-owner receives funds for his or her share of the business at a time when the money is greatly needed. And the business is no longer burdened with a co-owner unable to contribute to the company's success.

Funding the buy-sell agreement with critical illness insurance

Critical illness insurance works hand in hand with disability insurance. Where disability insurance covers people who are no longer able to work, critical illness insurance pays a benefit when you're diagnosed with one of many illnesses – even if you can still show up for work.

This distinction is very important for co-owners of a business. What happens to the business if a co-owner suffers a critical illness then returns to work with only limited capabilities? The business and the co-owner can be better off when the healthy co-owners buy out the business interest of the critically ill co-owner.

And the risks to the business involve more than returning to work at less than full capacity. Business will suffer while the co-owner recovers at home or hospital, and of course the co-owner may never return to work. Possible consequences include decreased productivity and revenue, lost clients and staff turnover.

All critical illness policies cover cancer, heart attack and stroke, and many policies cover approximately 20 other conditions and illnesses.

The probability of suffering a critical illness makes this type of insurance important to your buy-sell agreement*:

- One out of four Canadians will develop heart disease.
- One out of three people will develop some type of cancer.
- About half of all heart attacks happen to people during their working years.
- On average, a stroke occurs every 10 minutes in Canada.

**Heart and Stroke Foundation of Canada, National Cancer Institute of Canada.*

Generally, the business can receive a lump sum benefit 30 to 90 days after the critical illness is diagnosed, which is used to buy the critically ill co-owner's business interest.

The business will be able to operate with co-owners who are all working at full capacity, and the critically ill co-owner receives funds for the business interest at a time when it will greatly enhance his or her quality of life.

Extremely important to note is that you can choose an option that reimburses premiums. If a critical illness benefit has not been paid out after a specified number of years, the business can be reimbursed for all premiums paid.

The next step in developing an insured buy-sell agreement

Developing a buy-sell agreement is a sophisticated process involving all co-owners, your Assante advisor, experts from Assante Estate and Insurance Services Inc., your lawyer, tax accountant and any other members of your financial team. The discussion begins by determining which situations potentially resulting in the departure of a co-owner you wish to cover in the agreement. That discussion leads to the eventual drafting of the buy-sell agreement.

When it comes to funding the agreement with insurance, making it an "insured buy-sell agreement," your Assante advisor will review the various methods available. You'll learn about the criss-cross method, promissory note method and corporate redemption method.

However, it all begins by contacting your Assante advisor, who will initiate the process of ensuring that you, your co-owners and your business are fully protected against the departure of a co-owner.

For more information

For additional information, or to learn more about Assante Estate and Insurance Services Inc., please contact your Assante advisor or visit www.assante.com.

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