



Buy/Sell Agreements - Criss-Cross Purchase Method

Introduction

This Tax Topic is a continuation of our examination of buy/sell agreements which started with the Tax Topic entitled "Buy/Sell Agreements - Some Preliminary Considerations". This Tax Topic deals with the criss-cross purchase method of handling a buy/sell commitment using personally-owned insurance. For a discussion of alternative methods for buy/sell agreements, refer to Tax Topics entitled "Buy/Sell Agreements - Promissory Note Method", "Buy/Sell Agreements - Corporate Redemption Method" and "Buy/Sell Agreements - Hybrid Method".

Fact Situation

The criss-cross method of arranging a buy/sell agreement is often the simplest method. The buy/sell agreement is between the shareholders or between the shareholders and a trustee but does not involve the corporation. Typically, the purchase price is funded utilizing life insurance. The insurance funding the buy/sell commitment is owned by the shareholders on the lives of each other or in more complex cases, by a trustee on behalf of the shareholders. The shareholders pay the premiums and either the shareholders or a trustee is the beneficiary under the policies.

For the purposes of discussion, the following facts will be assumed:

1. A and B are equal shareholders in Opco, a Canadian-controlled private corporation.
2. The adjusted cost base (ACB) of each shareholder's shares is \$100.
3. The shares in Opco have a fair market value of \$400,000.
4. A buy/sell agreement is in place between A and B which is fully funded by personally-owned insurance. In other words, A owns an insurance policy on the life of B for \$200,000 and B owns an insurance policy on the life of A for \$200,000.
5. The shareholders deal at arm's length for purposes of the Income Tax Act (the Act).

Transactions on Death of a Shareholder

Upon the death of A, for example, B would be obligated under the buy/sell agreement to purchase the shares of A from his/her estate, at the value specified in the agreement, using the funds from the life insurance policy. The estate of A would be obligated to sell the deceased's shares to B.

Income Tax Consequences

The attached Appendix shows the detailed tax consequences of the above transactions. A summary of these tax consequences follows.

1. Tax Consequences to the Deceased Shareholder

Upon his/her death, A would be deemed by subsection 70(5) of the Act to have disposed of his/her shares in Opco at their fair market value of \$200,000 immediately prior to death. This deemed disposition will generate a capital gain of \$199,900, the extent to which the fair

market value exceeds the adjusted cost base of the shares. The capital gain will be reported on A's terminal tax return. All or a portion of this gain may be offset by A's unutilized capital gains exemption.

2. Tax Consequences to the Deceased Shareholder's Estate

A's estate will acquire the shares from A with an adjusted cost base equal to the deemed proceeds of disposition on the terminal return, \$200,000. When the estate sells the shares to B pursuant to the buy/sell agreement, a gain or loss would be realized by the estate to the extent that the purchase price varied from the fair market value. In this situation, no gain or loss is realized.

If the fair market value of the shares was greater than the buy/sell price of \$200,000 assumed in our example, a loss would be incurred by the estate on the subsequent sale to B. This capital loss could be carried back to the deceased's final tax return under subsection 164(6) of the Act to offset the capital gain in the terminal return, provided the transaction is completed within the first taxation year of the estate.

3. Tax Consequences to the Surviving Shareholder

B would receive the proceeds of the life insurance on A on a tax-free basis. Using these funds, B would purchase A's shares at the amount specified in the agreement (\$200,000). The adjusted cost base of B's original shares and the newly-acquired shares would be averaged for the purposes of determining any gain or loss upon the subsequent disposition of those shares.

Use of a Trustee

A trustee is sometimes used in a criss-cross buy/sell agreement to simplify the ownership of insurance and the mechanics of the buy/sell on death. A trustee is most commonly used when there are more than two shareholders. The ownership of insurance policies can become complex when each shareholder purchases policies on the other shareholders in proportion to their buy/sell commitments. With a trustee, a single policy can be purchased on each shareholder with the Trustee as owner and beneficiary.

For example, if there are four shareholders A, B, C and D and no trustee involved in the buy/sell agreement, then A must purchase policies on each of B, C and D covering his/her share of the buy/sell commitment. In turn, B must purchase policies on A, C, and D and so on. This would lead to 12 policies being in existence initially plus any additional policies required to fund increases in the fair market value of the shares over time. If a trustee is involved in the buy/sell agreement, then a single policy is purchased on the life of each shareholder covering the purchase of that individual's shares. The Trustee would be the owner and beneficiary of the policies and would have the responsibility for collecting the proceeds in the event of death and carrying out the buy/sell arrangement. Using a trustee, there would only be 4 policies issued initially to fund the buy/sell.

Typically, when a trustee arrangement is used, the Trustee purchases all of the shares of the deceased shareholder. The shares are purchased for the benefit of the surviving shareholders, and at fair market value. The deceased's shares are allocated to the surviving shareholder's as beneficiaries of the Trust in proportion to each shareholder's respective shareholdings.

The use of a trustee also allows for the policing of premium payments as a shareholder can inquire of the Trustee if there are any outstanding amounts. Without a trustee, the shareholders must rely on each other to ensure that the policies are kept in force.

If a trustee is included in the buy/sell agreement, there should also be a separate trust agreement stating the duties and responsibilities of the Trustee and the terms of the trust.

The use of a trustee would have no impact on the tax consequences discussed above, assuming the trust owned exempt life insurance policies and no income producing property.

Use of Personally-Owned Insurance

The criss-cross method uses personally-owned insurance, whereas the promissory note method, the corporate redemption method and the hybrid method use corporate-owned insurance. This has several implications which are discussed in detail in the Tax Topic entitled "Buy/Sell Agreements - Some Preliminary Considerations" and which are summarized below.

The premiums payable on a life insurance contract are generally not deductible for income tax purposes. It will therefore be most cost effective to have the policies corporate-owned if the corporation would be in a lower tax bracket than the individual shareholders (so that the premiums are paid with cheaper corporate dollars).

Where the insurance policies are individually-owned, it may be difficult for the shareholders to be certain that premiums are being paid and that the policies are being kept in-force. With corporate-owned policies, this is less of a concern. However, as previously mentioned, the use of a trustee to own the policies and collect the premiums may alleviate this concern.

The cost of premiums may be felt to be inequitable with individually-owned policies, where there is an age difference or difference in the state of health of the shareholders. The younger or healthier shareholder will pay higher premiums for insurance on the older or less healthy shareholder. This may be considered an equitable sharing of the risk but it does represent an unequal financial burden. With corporate-owned insurance, the shareholders will share the cost of this insurance in proportion to their shareholdings rather than in relation to the age or health of each shareholder. A similar arrangement could be put in place through the use of a trustees agreement. The Trustees owning the insurance policies could require the individuals to contribute equally to the costs of the trust.

Proceeds from a life insurance policy which are received directly as a result of the death of the life insured will be excluded from the beneficiary's "net family property" for purposes of the Ontario Family Law Act (1986). The effect of this is to exempt such proceeds from the claim of a spouse upon separation, divorce or death. In addition, any property acquired (other than a matrimonial home) with these proceeds will be excluded from the beneficiary's net family property. Proceeds from a corporate-owned life insurance policy do not have similar protection when flowed out to shareholders and will be included in net family property. If the insurance proceeds pass through a trustee who purchases the deceased's shares on behalf of the surviving shareholder, the death benefit loses its character as life insurance proceeds and as a result, there will be an increase in the survivor's net family property in Ontario.

A policy that is owned by a corporation should not be connected or form part of the estate for the purposes of making a claim against the policy for child support. The Ontario case of Goodis (Litigation guardian of) v. Goodis Estate [2003] O.J. No. 3564 confirmed this premise.

When personally-owned insurance is used to fund the buy/sell commitment, the proceeds of the insurance are not subject to claims of the corporation's creditors, unlike corporate-owned insurance. However, the insurance will be subject to the claims of personal creditors or creditors who have obtained a personal guarantee of business debts.

Several valuation issues can arise when corporate-owned insurance is used to fund a buy/sell agreement, for example, the valuation of shares on a non-arm's length purchase, the valuation of shares on death, valuation for purposes of the deceased shareholder's ability to claim the capital gains exemption, etc. The use of insurance owned outside of the corporation will avoid these issues.

Another situation where personally-owned insurance may be the recommended method occurs where the proportion of shares to be owned after a disposition under a buy/sell agreement is different than the original proportions. For example, if the original shareholdings are 20/30/50 and the ownership after a disposition under the buy/sell agreement is 25/75. Any arrangement of corporate-owned insurance will not accomplish this. In the event that the promissory note method is utilized, the payment of the capital dividend in amounts proportional to shareholdings will not permit a full repayment of the promissory note. Similarly, a redemption of shares will not accomplish any change in the proportional shareholdings of the remaining shareholders.

Conclusion

The criss-cross method of arranging a buy/sell agreement is the simplest method in terms of tax complexity and the mechanics of carrying out the buy/sell on death.

In general, the criss-cross purchase method should be considered when the tax rate of company's owners is the same as, or lower than, the tax rate of the company itself. However, the greater tax planning flexibility of the "hybrid" buy/sell structure should also be considered.

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Last updated: November 2005



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Appendix

Criss-Cross Purchase Detailed Tax Calculation

1. To the Deceased

Deemed proceeds on death (ss 70(5))	\$200,000
Less adjusted cost base of shares	<u>100</u>
Capital gain	199,900
Capital gains exemption	<u>?</u>
Net Capital gain	<u>\$ 199,900</u>

2. To the Deceased's Estate

Proceeds from sale	\$200,000
Less adjusted cost base of shares (ss70(5))	<u>200,000</u>
Capital gain	<u>Nil</u>

3. To the Surviving Shareholder

Total value of shares	\$400,000
Adjusted cost base of original shares	100
Plus adjusted cost base of new shares	<u>200,000</u>
Total adjusted cost base of shares	<u>\$200,100</u>
Potential capital gain	<u>\$199,900</u>