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Business Owners: Revisiting the Buy-Sell Agreement

For business owners who want to ensure a successful transition of their company, buy-sell agreements on death, whether stand-alone or as part of a shareholders' agreement, are an important consideration. Here are some things to think about when preparing or reviewing an agreement:

Funding the Buy-Sell — The effectiveness of the buy-sell provisions oftentimes depends on the ability of the surviving shareholder(s) or the company to fund the transaction. If funds are not readily available, the company may need to sell assets or obtain external financing, which may negatively impact operations.

If the company has accumulated cash to fund the buy-sell, this surplus may be viewed as a passive asset that results in the shares of the company not qualifying for the lifetime capital gains exemption, foregoing tax savings.

Tax Implications — Tax implications will depend on whether the buy-sell agreement requires the purchase of shares by a surviving shareholder or a share redemption/purchase for cancellation by the company. A share purchase may give rise to capital gains in the hands of the selling shareholder or his/her estate, while a share purchase by the corporation (known as a purchase for cancellation) may result in a deemed dividend.

In certain provinces, capital gains are generally subject to a lower rate of tax than dividend income. The difference between these two approaches can be further magnified if the capital gains exemption is available.

However, if life insurance is used to fund the purchase obligations under the agreement, all or a portion of the proceeds may be received as a tax-free dividend through use of the company's capital dividend account (CDA).

Hybrid buy-sell provisions that allow for a share purchase and/or redemption/purchase for cancellation can provide greater flexibility for tax planning purposes.

Capital Dividend Account — If corporate insurance exists, the buy-sell terms must specify that the company treats dividends paid to the deceased shareholder, to the extent of the insurance proceeds, as tax-free capital dividends. Otherwise, case law provides that surviving shareholders could make the dividends to the deceased's estate taxable and retain the CDA for their own future benefit.

As always, we recommend seeking professional advice when preparing or reviewing the buy-sell agreement as it relates to your particular situation.

Dekker Hewett Group
Canaccord Genuity Wealth Management
609 Granville St., Vancouver, BC, V7Y1H2
T: 604.699.0852
E: dhginfo@canaccord.com
www.dekkerhewettgroup.com