



# Business Continuation *Planning*



## OWNERS GUIDE

A guide to protecting the profitability  
and viability of your business



Sun   
Life Financial



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The material is current as of June 2001.

Sun Life Financial is a proud sponsor of CAFE, the Canadian Association of Family Enterprise, since 1998. CAFE is a non-profit organization dedicated exclusively to the support of family business. The statistics are clear – 70 per cent of family businesses do not survive the transition to a second generation; 90 per cent do not make it to a third generation. CAFE has become a powerful resource for families wanting to overcome these challenges and beat the odds.



# What is *business continuation planning?*

Business continuation planning is the process of identifying risks that may imperil your business, such as the death or disability of a key employee or owner – and adopting risk management strategies to minimize, eliminate or transfer these risks.

There are good reasons for addressing these risks. While a business represents a source of current income for many business owners, the value of the business can also represent a primary source of income in retirement. Business continuation strategies are critical not only for the immediate survival of the business, but to ensure that the business can be relied upon to generate the expected value for the owner when they exit the business.

This Guide provides an overview of some key strategies that can help you protect the profitability and viability of your business. It also provides a more detailed look at the ways in which life insurance can be used to fund many of these strategies.



# Key person *protection*

While most business owners understand the need to protect against unforeseeable risks related to their capital assets – fire and theft for example – risks relating to another key asset, human capital, are often overlooked.

These risks involve the loss of key personnel due to death, disability, or critical illness. Such events can threaten the viability of your business, and the risks are far from remote.

For a 40-year-old employee, there's a 60 per cent chance that they will become disabled for a period of three months or more before the age of 65. Where a disability of over three months does occur, the average duration is between three and four years. The odds of an employee dying are less than this, but are still significant.

**What are the potential threats to your business? There are several:**

- Your business performance may lag due to the absence of the individual.
- You could incur costs to replace the individual.
- Creditors may restrict or withdraw credit.
- Suppliers may tighten payment terms.
- Customers may reconsider using the business as a supplier of product or service.
- Other employees may be enticed to other career opportunities if there is confusion and uncertainty surrounding the event.

The good news is that these risks can be managed. A risk management strategy involving insurance protection can help minimize the impact of the loss of key personnel.

Identifying your key people

Who are the key people in your business? The question may not be relevant for owners of very small businesses or those in the early stage of development, but as a business grows in size and cash flow, key employees will evolve. You might consider someone a key employee if they:

- Are involved in sales or for other reasons have developed personal goodwill with important customers.
- Have unique technical knowledge or skills that are difficult to replace or would have to be replaced at a much higher cost.
- Have identifiable skills that create a positive disposition by lenders to provide credit.

**While it can be challenging to identify key people other than you and your co-owners, it's important to critically assess employees and objectively assess the cost to your business if that employee were lost.**

## Assessing your potential losses

Once you've identified your key personnel, you need to assess your potential sources of loss.

These might include:

- The cost of searching, recruiting and attracting an equally effective replacement.
- The cost of temporary support hired or contracted in the interim period.
- The estimated loss in productivity or revenue until an equally effective replacement is up and running.
- Business loans that may be called or for which there is a desire to retire.
- Lines of credit that may be reduced or retracted.
- The impact of some suppliers moving to cash on delivery for a period of time.
- The increased cost of debt service if carrying charges are increased.

Quantifying your potential loss is often an art as much as a science, but it's a necessary process in order to determine the amount of insurance protection that your business will need.

*For an example of how potential losses might be quantified – see Appendix A.*

## How key person insurance can help

While it may be possible for a business to retain their key person risk if the potential losses are small enough, the impact of a loss for some businesses can often be sufficiently catastrophic to destroy the viability of the business. The business simply won't have the cash flow or available credit to withstand the losses and credit contraction that would occur.

In such cases, many businesses choose to transfer the risk, usually through the purchase of life, disability, or critical illness insurance. The insurance proceeds can ensure there is an injection of liquid capital to allow family or management time to appoint and pay for interim management, pay off creditors, and cover the cost to the business of the lost key person. The availability of this cash, along with a viable transition plan, can also act to reassure employees, creditors, suppliers, and customers.

Here is an overview of the three types of insurance typically used to provide key person protection.

### **Key person life insurance**

Life insurance is usually the cornerstone of a key person protection strategy. It provides an instantaneous injection of capital into the business upon the death of the key person. Death benefits are received by the company tax-free.

Renewable term insurance is usually the most economical option over the short-term. However, there are situations in which a more permanent insurance solution should be considered, such as when protection is expected to extend over a longer time frame, or there is a need to create a funded supplemental compensation structure for the insured individual.

### **Key person disability insurance**

Disability insurance can be used for two purposes in a key person context:

- The insurance can provide salary continuation to a key person in the event they become disabled, usually until the earlier of age 65 or recovery from the disability.
- Owner-managers can purchase insurance that provides continued payment of office expenses and salaries during the period of disability, usually for a limited time period.

### **Critical illness insurance**

Critical illness insurance provides protection in a situation where a key person is afflicted by specified diseases or health problems that do not necessarily render them disabled but nevertheless affect their productivity or their desire to work to the same extent as before.

This coverage will pay a lump sum, or in some cases a stream of income, to the business to help cover losses created by the absence or lower productivity of the individual.



# Sole owner *protection*

A sole owner is by definition a key person, and in many business situations may be the only key person. But the business continuation issues for sole owners differ in many ways from those involving other key persons.

Very small businesses, or those in the early stage of development, may not be sustainable in the absence of a sole owner. Often, the owner is the business. In that instance, life, disability or critical illness insurance will likely be useful only from the standpoint of income replacement for the owner's family. It could also help provide the cash flow required to terminate the business, including payment of liquidation fees, and other debts like income tax due at that time, rather than for business continuation purposes.

In other situations, however, the business has grown beyond the sole owner and has a sustainable value, even in the owner's absence. In such cases, insurance protection may be needed for additional reasons.

**If a sole owner dies for example, additional funding may be needed for a number of reasons:**

- The potential sources of loss associated with the loss of a key person, such as lower productivity and reduced or retracted credit, are even more likely to occur if the key person lost is the sole owner.
- Even if productivity is lower the business must continue to pay staff and cover other overhead expenses.
- Time may be needed to find an appropriate buyer for the business. The additional funding that insurance protection provides can buy the time needed to sell the business to the right buyer at the right price.
- The deemed disposition of assets at death can lead to a significant tax liability for the owner's estate. Insurance proceeds can cover this liability, without requiring the estate to liquidate other assets.

**While the protection solutions for sole owners – life, disability and critical illness insurance – are the same as for other key persons, the risks covered will differ due to the central role and equity position that the owner enjoys.**



# Protecting your business *if a co-owner dies*

While key person protection is an important element of business continuation planning, it can be even more crucial to address the potential issues that can arise upon the death of a co-owner.

Many businesses have multiple co-owners, either through a partnership or through share ownership. If one of the owners dies, this could have a serious impact on your business. The reason? Upon death, a co-owner's business interest will pass immediately to one or more of the owner's heirs, such as their spouse. The business suddenly has a new owner in the mix, regardless of whether the new owner has the qualifications or experience to actively participate in the business. The potential for such an event requires special planning to ensure a smooth transition and to minimize the business risks.

## How death changes everything

When a co-owner dies, the surviving business owners usually have five options in dealing with the deceased owner's business interest. Here is a brief description of each:

- **Buy-out the heirs:** This is usually the most preferred option. After all, the surviving owners know how to run their business. It usually makes sense to buy-out the heirs and carry on business from there, especially in cases where the heirs lack

business expertise or interest in running the business.

- **Keep the heirs in the business:** While heirs can remain as owners in either an active or inactive role, there are risks to this arrangement, in particular the potential for conflicting opinions about key issues such as compensation and the overall direction of the business.
- **Take on an outsider who purchases the deceased's business interest:** Outside buyers are seldom interested in purchasing a deceased's business interest in a closely-held business. However, if the situation does occur, the risk lies in the new owner not sharing the same business vision as current owners, and the potential for strains in the working relationship.
- **Sell to the heirs:** This alternative is feasible if the current owners are at a stage where they want to sell, and the heirs are qualified to operate the business and have access to adequate capital.
- **Liquidate the business or sell to a third party:** Unless an alternative can be agreed upon, the sale or liquidation of the business may be the only option, although it is far from ideal as only a fraction of going concern value may be realized, and the liquidation proceeds may not be enough to pay the tax and meet other estate obligations.

## The need for a buy-sell agreement

To avoid the potential problems associated with the options described above, advance planning is essential. One of the most effective planning tools is a buy-sell agreement.

A buy-sell agreement can take the form of a stand-alone contract or form part of an overall shareholder's agreement. Such agreements set out the conditions in which an owner has the right to buy the ownership share of another owner. This can include items such as how the business will be valued and the method and conditions of payment. The agreement can also govern the conditions of a voluntary sale of the business by one or more owners.

The buy-sell agreement on its own, however, does not provide the protection that the owners and business require in the event of an owner's death. For the buy-sell agreement to be effective, it must be properly funded. Surviving owners need a source of funds to not only buy out the deceased owner's interest, but to boost the organization's working capital if necessary to compensate for the loss of the deceased's services and financial backing.

A properly constructed and funded buy-sell agreement provides benefits to all parties. It can address the needs of the deceased's heirs by providing full value and a guaranteed and timely cash payment for what is in most cases a fairly illiquid asset.

For the surviving owners, a properly funded agreement ensures the deceased's family members will not have to be involved in the business, and that the business can continue uninterrupted without additional debt. It can also ensure that the confidence of employees, creditors, and customers can be maintained.

Because there are tax consequences to the various methods of funding, it's also important that the funding arrangement be structured to minimize the short and long-term tax consequences for both the deceased and their estate, and the surviving owners.

## A buy-sell agreement has many uses

While this Guide discusses the use of a buy-sell agreement in the event of the death of an owner, an agreement can also cover other situations, such as:

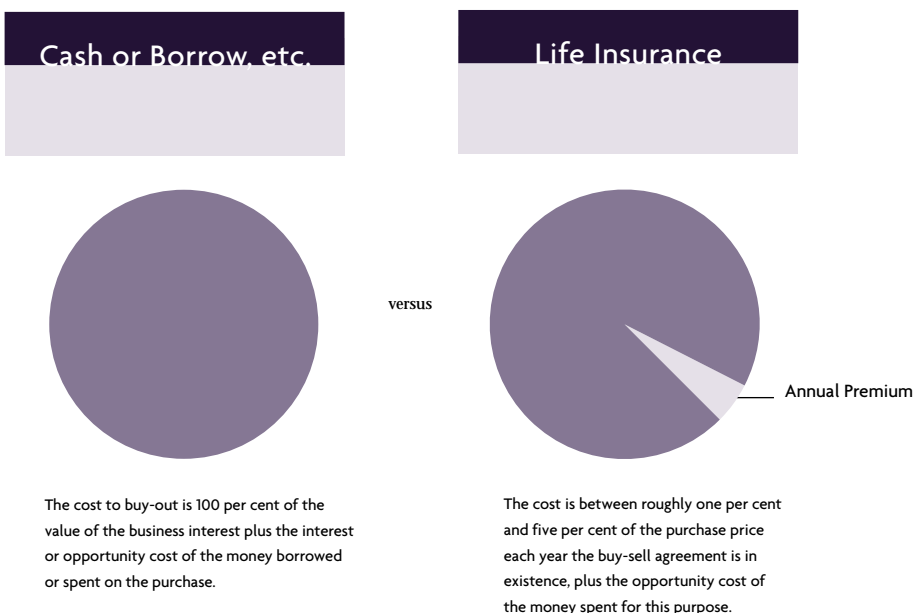
- The retirement or disability of an owner.
- A non-resolvable dispute between owners.
- Marital breakdown, where an owner's spouse has, or has become entitled to an interest in the business.
- Personal insolvency of an owner.
- Any illegal actions by an owner.

## Funding options for a buy-sell agreement

There are several ways to access the necessary funding to buy-out a deceased owner's business interest under a buy-sell agreement. Here is a brief overview of each:

- **Borrow the funds:** If the business has a good credit rating it can borrow the funds needed to buy-out the heirs. However, it's important to remember that while the business may be a good credit risk today there is no guarantee it will be in the same position many years later.
- **Issue a promissory note:** A promissory note is an unconditional written promise to pay for the deceased owner's shares. The main shortcoming of this arrangement is that it doesn't provide the deceased owner's estate with an immediate, and often much needed, cash payment.
- **Use business earnings:** Business earnings can be used to either fund repayment of a promissory note or to pay the surviving owners to fund the purchase. This is a viable option if the business is in a solid cash position, but it could deprive the business of needed capital to grow and expand.
- **Sell business assets:** Selling assets can be a problematic choice since the timing of the sale is dictated by an outside event – the death of an owner – and not on market conditions. This means the business may get less than full value for the asset.
- **Use life insurance:** A life insurance policy on the life of each business owner is a relatively low cost alternative to other funding methods, and provides the necessary cash immediately upon death. While the business must pay an annual premium amount for the insurance coverage, the premium is relatively low when compared to the tax-free proceeds that the business would receive should a death occur.

## Comparative cost of alternative funding methods for a buy-sell agreement at death





# Funding a buy-sell *agreement using life insurance*

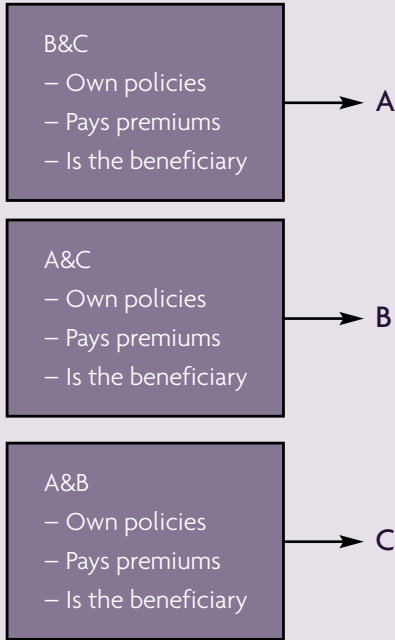
Life insurance not only provides effective low-cost funding of a buy-sell agreement, it also offers considerable flexibility in how an arrangement is structured.

The life insurance funding arrangement that works best for your business will depend on many factors, such as the date the arrangement was put in place, your specific business continuation needs, and the structure of your business.

This section of the Guide provides a quick overview of the funding arrangements available, and then sets out more detailed examples and analysis of how each arrangement works from a tax standpoint.

## Individually-owned criss-cross

The chart below shows how this structure would work in a three-owner business.

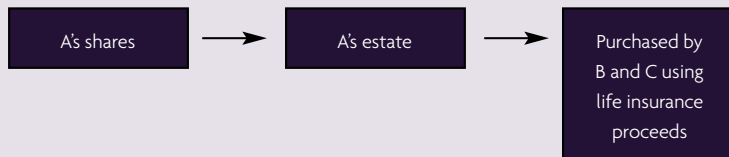


With an individually-owned criss-cross structure, the business owners enter into a buy-sell agreement where in the event of death, the surviving owners agree to buy the ownership interest from the estate of the deceased. In addition, each of the owners ensures their estate is bound to sell their ownership interest to the survivors in the event they should die.

Life insurance is purchased by the owners on each other. In the event of death, the insurance proceeds are received by the surviving owners tax-free and are used to purchase the deceased's ownership interest.

The personal criss-cross arrangement is not typically used with an incorporated business, as it is usually more advantageous for the business to pay the premiums based on the lower corporate tax rate than for the individual to pay the premiums with his own after-tax money. The individually-owned criss-cross structure is most often used in a partnership situation.

If A dies:



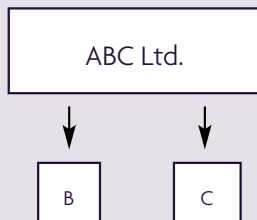
- Each shareholder owns a life insurance policy on the lives of the other shareholders.
- Surviving shareholders use life insurance proceeds to purchase shares of the deceased shareholder.

### The consequences

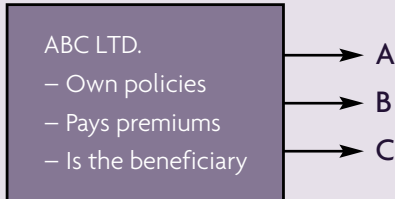
This scenario makes the money required to buy-out the heirs available to the surviving partners through the tax-free insurance proceeds. However, the net value for the estate will be reduced by the amount of the tax due in the deceased's final tax return on the deemed capital gain realized at death. The surviving partner takes advantage of an increase in the Adjusted Cost Basis (ACB) that reduces his own latent capital gain on disposition.

*For detailed examples of the cash flow and tax position – see Appendix B.*

### The result:



## Corporate-owned criss-cross



With a corporate-owned criss-cross structure, the business owners enter into a buy-sell agreement with provisions similar to the individually-owned structure.

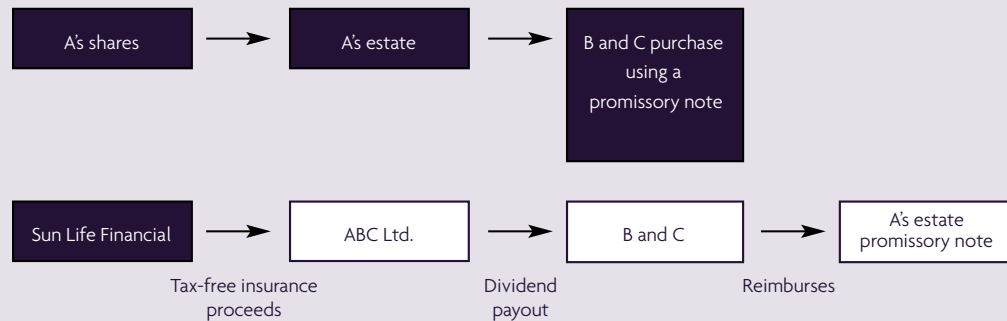
However, the life insurance funding and the mechanics of the sale are different. Life insurance is purchased by the corporation on the lives of owners – rather than purchased by each individual owner. On the death of an owner, the deceased's shares are acquired from the estate by the surviving owners in exchange for a promissory note to pay for these shares at a future date.

The insurance proceeds are received by the corporation tax-free, and the amount in excess of the ACB of the policy is credited to the corporation's capital dividend account. Dividends are paid to the surviving owners, and an election is made under the *Income Tax Act* (Canada) to treat the dividend as a tax-free capital dividend.

These dividend payments are then used to repay the promissory note. Assuming the ACB of the insurance policy is nil at the time of death, the tax consequences of the promissory note method are identical to the individually-owned criss-cross method.

If there is a value attached to the policy's ACB, there will be a taxable dividend equal to this ACB.

### If A dies:



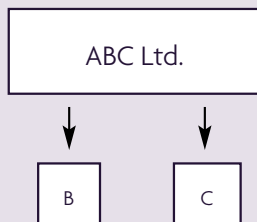
- A's estate receives fair market value for A's shares.
- B and C own 100 per cent of ABC Ltd.

### The consequences

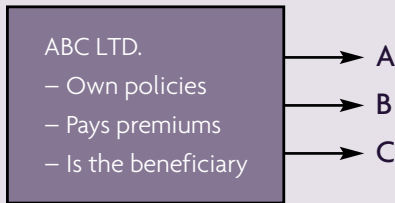
This scenario shows final cash flow and tax results similar to those illustrated in the individual criss-cross above, although it is very different from an application standpoint.

For detailed examples of the cash flow and tax position – see Appendix B.

### The result:



## Corporate-owned share redemption



With a corporate redemption arrangement, the business owners enter into a buy-sell agreement with the corporation and agree that the deceased shareholder's estate is obligated to sell and that the corporation is obligated to redeem the shares of the deceased.

While this can be the most beneficial funding arrangement from a tax standpoint, it's also the most complex.

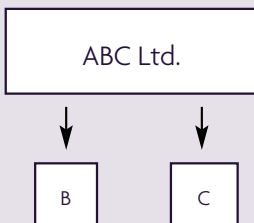
Here's why. The tax rules relating to corporate redemption arrangements changed on April 26, 1995. Agreements made in writing before April 27, 1995 – and policies which existed on April 26, 1995 for the purpose of funding a redemption of shares – are subject to the old tax rules. Agreements and policies put in place after those dates are subject to more restrictive stop-loss tax rules.

If A dies:



- Corporate-owned life insurance policy on each shareholder.
- Corporation redeems shares of deceased shareholder.
- A's estate receives fair market value for A's shares.
- B and C own 100 per cent of ABC Ltd.

**The result:**



## Stop-loss rules explained

Under the old tax rules, which apply to arrangements or policies in effect before April 27, 1995 or policies in-force on April 26, 1995, the estate of a deceased shareholder could reduce its taxable capital gain to zero by declaring a capital loss equal to the amount of the capital dividends received when the corporation redeemed its shares. The stop-loss rules under subsection 112(3.2) of the *Income Tax Act (Canada)* do just what the name suggests, they reduce the capital loss that the estate can claim.

Under the stop-loss rules, the estate's capital loss is determined to be the lesser of:

- (1) capital dividends on the shares received by the estate, and
- (2) the capital loss minus any taxable dividend received by the estate.

Minus 50 per cent of the lessor of:

- (a) the deceased's capital gain from the deemed disposition at death, and
- (b) the estate's capital loss.

## Be careful with grandfathered arrangements

In order to maintain the privilege of grandfathering under the pre-stop-loss tax rules, the owners must be very careful when any further transactions are contemplated, such as:

- The sale of the shares to a third party who is not party to the buy-sell agreement.
- Corporate reorganizations and mergers.
- Revisions to the terms of the existing buy-sell agreement.
- Entering into a new separate buy-sell agreement that cancels, nullifies or replaces the grandfathered agreement.

In contrast, a very broad range of changes could occur on an existing life insurance policy, up to cancellation and replacement, without resulting in the loss of the old rules. Nevertheless, the policyholder must be able to document that the main purpose for purchasing the policy was to fund the redemption, acquisition or cancellation of shares. So a safe keeping of documents issued by the life insurance company, minutes of the corporation, and any correspondence from a legal advisor and accountant, is highly recommended.

For arrangements under the old rules, the corporation would purchase insurance on the lives of the shareholders. In the event of death, the corporation would redeem the shares of the deceased owner from the estate by declaring a tax-free capital dividend – assuming the ACB of the life insurance policy is nil. The redeemed shares would be cancelled, with the surviving owners now owning 100 per cent of the outstanding shares.

Arrangements which avoid the stop-loss rules are beneficial to a deceased's estate from a tax standpoint, although surviving owners do not benefit from any increase in the ACB of their shares after the redemption takes place.

If an arrangement falls under the stop-loss rules, the corporation can still redeem the shares of the deceased owner, but for tax reasons, may declare a tax-free capital dividend of less than 100 per cent of the insurance proceeds.

Alternative strategies which have been developed to work with the stop-loss rules seek to maximize the value of the life insurance for the corporation and the shareholders and to avoid the wasting of capital dividend account credits. In effect, there is now an opportunity for a more equitable spreading of the tax burden between the deceased's estate and the surviving owners.

*For alternative strategies – see page 14.*

*For detailed examples of the tax treatment under corporate redemption arrangements – see Appendix C.*

Strategies to maximize immediate tax effectiveness

The stop-loss rules have reduced the tax advantages enjoyed by a deceased owner's estate when the owner's shares are redeemed by the company. But the rules have also prompted business owners to look at alternative ways to structure corporate redemption arrangements to maximize the immediate tax advantages still available. Here are three alternate strategies to consider:

#### **Rollover and redeem**

If an owner dies and is survived by his or her spouse, the shares can be transferred to a spouse or a spousal trust, on a tax-free rollover basis. To qualify for a tax-deferred rollover, the shares must vest indefeasibly with the spouse. If certain conditions are met, the share redemption could be done with no limitation through a tax-free capital dividend. However, some other stop-loss rules could apply in such circumstances, so great care must be taken in drafting the agreement and the owner's Will.

#### **The 50 per cent solution**

The 50 per cent solution refers to the percentage of the life insurance proceeds that a company deems to be a capital dividend. Here's how it works. After the death of an owner, the life insurance proceeds received by the company are used to redeem the deceased's shares from the estate. The portion of the dividend deemed to be a capital dividend will be the lesser of 50 per cent of the deemed gain on disposal, or 50 per cent of the loss realized by the estate. The balance of the redemption price is treated as a regular taxable dividend. There is also a capital dividend account credit retained by the company and used for the distribution of tax-free dividends for future earnings.

Why choose 50 per cent instead of some other percentage for a deemed capital dividend? Even though the deceased's estate will have a higher immediate tax bill, the total tax payable by all parties is considerably less when the arrangement as a whole is taken into account.

*For a detailed example of how the 50 per cent solution works for shares that do not qualify for grandfathering under the stop-loss rules – see Appendix D.*

*For a tax comparison of the total tax burden between the 50 per cent deemed capital dividend and a 100 per cent deemed capital dividend – see Appendix E.*

#### **Redeem and cross-purchase**

Upon the death of an owner, 50 per cent of the deceased's shares are redeemed with the life insurance proceeds, and a capital dividend election is made for the amount paid. The balance of the shares are bought after a corporate reorganization where new shares – or a demand note – are issued for the remaining.

The remaining 50 per cent of the insurance proceeds are distributed to the surviving shareholders as a tax-free capital dividend. This amount is used to acquire the newly issued shares or to repay the demand note from the estate. This triggers an increase in the ACB of the shares owned by the surviving owner. This solution also allows the deceased owner to take advantage of the \$500,000 small business capital gain exemption if available.

*For a detailed example of a redeem and cross-purchase arrangement – see Appendix E.*

## Use of a holding company structure

**In some situations, the use of insurance to fund a buy-sell agreement is most effective when a holding company structure is established. With such a structure, the holding company owns shares of the business – the operating company. The holding company would also own the life insurance that funds the buy-sell agreement. There are several buy-out strategies that could be put in place through the buy-sell agreement to respond to the needs of the shareholders for flexibility and tax advantages.**

**Here are some of the advantages that these strategies try to address:**

- The entire amount of the insurance proceeds can be credited to the capital dividend account when it is received by the operating company as long as *bona fide* business purposes are shown.
- If the holding company owns the policy, the cash value of the policy may be protected from creditors of the operating company, provided no guarantees have been made by the holding company to the creditors of the operating company.
- Because the cash value of the insurance policy belongs to the holding company, it will not taint or disqualify the use of the \$500,000 capital gains exemption in relation to the shares of the operating company.
- If the operating company is sold, the holding company will continue to own the insurance, and there will be no taxable disposition of the policy as the original policy owner is maintained.

**The benefits of using a holding company to own life insurance for business continuation purposes will vary depending on the corporate structure involved and the specific business continuation needs of your organization. But it can be an advantageous arrangement in many cases.**



# Finding an *appropriate business valuation method*

Business valuation is an integral part of the buy-sell planning process. The reason is simple, if a withdrawing event occurs, and one party must buy the business interest of another, the value of the interest must be determined for the sale to take place.

A business valuation is an examination conducted to estimate the fair market value of a business interest at a given point in time. Fair market value is defined as the highest price obtainable in an open and unrestricted market between knowledgeable, prudent and willing parties. These parties are fully informed, dealing at arm's length, and not under compulsion to act.

The valuation of a company is not an exact science. In particular, the valuation of a private company is complicated by several unique problems, including:

- Lack of information and comparability.
- Risk factors - determination of the multiplier.
- Personal goodwill.
- Normalization adjustments.
- Income tax issues.

For the purposes of buy-sell planning, the valuation should usually be performed at the time of the withdrawing event – such as death or disability. Some shareholder agreements require an annual update of the valuation of the shares. This allows for the insurance to be adjusted on an annual basis and ensures that the agreement remains appropriately funded. Ideally, the buy-sell agreement should either specify a valuation formula, or make reference to an accepted valuator to determine the value at the time the event occurs.

The method of valuation chosen for a buy-sell agreement will depend on the specifics of the situation, the goals and objectives of the shareholders, and the industry. In ascertaining a value for the business, a professional accountant or business valuator should be consulted.

**Here is a brief overview of several common business valuation methods.**

- **Capitalized earnings:** A maintainable level of operations is determined with reference to financial and operating risks.
- **Capitalized cash flow:** Before-tax historical and forecasted cash flows are determined, adjustments are made for unusual transactions and owner/management salaries and bonuses to determine the level of maintainable cash flow. The maintainable cash flow level is then capitalized by an appropriate multiple.
- **Discounted cash flow:** This method attempts to state in current dollars the value of future cash inflows and outflows. It is therefore most relevant for valuing concerns with a limited life, such as a natural resource company.
- **Adjusted net tangible equity:** With this method, all the assets and liabilities of the company are restated to their current market values. If shares are being valued, the tax-shield related to the incremental market value of depreciable assets should be deducted and consideration should be given to any contingent liabilities.
- **Liquidation:** This approach is used primarily when a business is no longer a viable concern and the liquidation value of its assets is higher than its going concern value.

**In certain industries, a rule of thumb may serve as a guide to valuation. For a detailed explanation of valuation methods, see “*Valuation of Businesses, A Practical Guide*” published by CCH Canada.**



# Corporate accounting and life insurance

The treatment of life insurance for accounting and tax purposes will depend on a number of factors, such as whether the policy is term or permanent insurance, when the policy was bought, and the business reasons for its purchase. Here is an overview of some key accounting and tax treatments relating to corporate-owned life insurance policies.

## Deductibility of premiums

In general, life insurance premiums are not deductible for tax purposes. When life insurance premiums are paid, the full amount is expensed. At year-end, an adjustment is made when filing the company's corporate tax return, with the premium amount added back into income for tax purposes.

There are some exceptions to this general rule, the most common being the ability to deduct a portion of the premium for tax purposes where the insurance is required as collateral against a debt owed to a restricted financial institution, such as a bank, trust company, or credit union.

Presenting cash surrender value (CSV) in the financial statements

Most permanent insurance policies have a cash surrender value. This is the amount of money the policy owner will receive if the policy owner cancels the coverage and surrenders the policy to the insurance company.

The cash surrender value of a corporate-owned life insurance policy is a corporate asset and should be included in the company's balance sheet. The materiality of the amount and the intention of the corporation's management will determine where the amount should be included.

If there is no intention to dispose of the policy, the cash surrender value should be classified in the "Non Current Asset" section under "Other Assets" or as "Life Insurance Cash Surrender Value." on the balance sheet. Disclosure is optional depending on the materiality of the amount. If management's intention is to do a full or partial disposition of the policy, the cash surrender value should be classified as "Cash and Cash Equivalents" in the "Current Assets" section of the balance sheet.

At the point in time that cash surrender values become available to the business, year-end adjustments should be made to the retained earnings account to set up the cash surrender

value in the financial statements. The adjustment could also be made to the income statement and then backed out of the income for tax purposes on the reconciliation of taxable income. The typical entry for an increase in cash surrender value of \$5,000 might be:

Other Assets – CSV	\$5000	
Retained Earnings – Investment Income		\$5000

Insurance proceeds and the capital dividend account

When a corporation is the owner and beneficiary of a life insurance policy, and the insured shareholder or employee dies, the portion of the life insurance proceeds that exceeds the ACB is included in the capital dividend account of the corporation for tax purposes.

The ACB is the base value from which accrued income and policy gains are measured, and changes with each policy transaction. ACB is defined in subparagraph 148(9) of the *Income Tax Act* (Canada).

The capital dividend account is a notional account that records tax-free amounts received by a Canadian resident privately-owned corporation. The purpose of this account is to allow a corporation to flow amounts it receives on a tax-free basis out to Canadian resident shareholders without creating tax in the shareholders' hands. An amount equal to the balance in the capital dividend account can be paid out as a tax-free capital dividend to shareholders, if proper tax elections are filed.

For example, if the life insurance proceeds are \$100,000 and the ACB of the policy is \$20,000, then \$80,000 can be credited to the capital dividend account and can be paid out as a tax-free dividend. The balance of the life insurance proceeds can be paid out as a taxable dividend to shareholders.

In the early years of a permanent life insurance policy the ACB may be high. In later years, the ACB will normally be low or non-existent.

The insurance policy carrier can provide an accurate calculation of your policy's ACB. Here is a quick look at the factors that will increase or decrease it:

**The ACB is increased by the following amounts:**

- For policies last acquired before December 2, 1982, the full premium for the policy, including premiums for all riders.
- For policies last acquired after December 1, 1982, the premium for the basic policy and term insurance riders paid by or on behalf of the owner of the policy, less the net cost of pure insurance (NCPI).
- The cost of all interests in the policy acquired by the owner of the policy.
- Policy gains previously included in income from dividends, policy loans received, etc.
- Certain policy loan repayments.
- Any mortality gain resulting from the death of the policyholder where an interest in the policy has been rolled over to the surviving spouse.

**ACB is decreased by the following amounts:**

- The total of all amounts, each of which is the proceeds of disposition of the policyholder's interest in the policy that the policyholder became entitled to receive before that time.
- The amount of a policy loan outstanding at March 31, 1978.
- For the policy acquired after December 1, 1982, all the premium related to an accidental death benefit, a disability benefit, an age rating or extra premium on account of a substandard life, a guaranteed insurability option and any other prescribed benefits that are ancillary to the policy (148(9)(e.1)(iii) ITA).

## Taxation on disposition of a policy

**The owner of the policy must include taxable policy gains in income for tax purposes. The taxable gain is equal to the proceeds of disposition, minus the ACB.**

### **Dispositions include:**

- A surrender, including a partial surrender such as a policy withdrawal and a transfer of funds to a segregated fund of the insurer. For a partial surrender, each dollar of cash value removed from the policy will be taxable in the same proportion as the total cash value would be if a full surrender occurred.
- Policy loans made after March 31, 1978, including automatic premium loans and capitalization of unpaid loan interest. Policy loans are considered to come first from the ACB on a tax-free basis and then from the taxable portion of the cash value.
- The dissolution of the owner's interest on maturity of the policy.
- A disposition by operation of law – such as voiding a policy.
- Lapse due to non-payment of premiums where the policy is not reinstated during the calendar year of lapse or within 60 days thereafter.
- Annuitization of a policy last acquired after December 1, 1982.



# About *Sun Life Financial*

Consumers want extra assurance that the company they deal with will pay death benefits for them in good economic times, and bad.

Sun Life Financial is a leading international financial services organization providing a diverse range of wealth accumulation and protection products and services to individuals and corporate customers. Tracing its roots back to 1871, Sun Life Financial and its partners today have operations in key markets worldwide, including Canada, the United States, the United Kingdom, Hong Kong, the Philippines, Japan, Indonesia, India and Bermuda. As of June 30, 2001 the Sun Life Financial group of companies has total assets under management of CDN \$326 billion.

Sun Life Financial Services of Canada Inc. trades on The Toronto (TSE), New York (NYSE) and Philippine (PSE) stock exchanges under ticker symbol "SLC", and on the London Stock Exchange under ticker symbol "SFC".

# Appendix A

## Quantifying potential key person losses

The chart below provides an example of how the losses associated with the death of a key person might be quantified. Although your business situation will likely differ from the example below, the example highlights some key steps in the assessment process.

<b>Profit loss</b>		
Annual normalized profits	\$400,000	
Percentage profit decrease due to death of key person	10%	
	\$40,000	
Number of years affected by loss of key person	3 years	
Lost profit		\$120,000
<b>Executive search costs</b>		
Search fee – usually a percentage of first year compensation		\$30,000
<b>Salary increase for successor employee</b>		
Excess of salary of replacement over that of deceased person	\$40,000	
Number of years you want to avoid paying excess from cash flow	2 years	
Cost of increased salary to be covered		\$80,000
<b>Training costs</b>		
Training costs for successor employee		\$5,000
<b>Debt repayment</b>		
Debt that may be demanded in full as a result of this death – e.g. line of credit contraction		\$150,000
<b>Credit charges</b>		
Supplier change in credit terms e.g. 90 days to COD – one time cost equal to one to three months purchases		\$50,000
<b>Cost of borrowing</b>		
Increase in cost of borrowing – e.g. total debt of 400,000 times one per cent increase in loan rate	\$4,000	
Number of years desired to cover this additional cost	2 years	
Cost of borrowing		\$8,000
<b>Total key person losses to be funded</b>		<b>\$443,000</b>

# Appendix B

## *Individually-owned and corporate-owned criss-cross method*

The following chart illustrates the tax treatment for the individually-owned and corporate-owned criss-cross methods\* of structuring a life insurance funding arrangement.

In this example, a corporation is owned equally by two shareholders. The business was started from scratch, with an ACB of \$0 for each owner. The business is now worth \$2,000,000. Therefore, the shares of each owner are worth \$1,000,000.

<b>(A) To the deceased shareholder</b>	
Deemed proceeds at fair market value (FMV)	\$1,000,000
ACB of shares	nil
Capital gain	\$1,000,000
<b>At a 28 per cent tax rate, the Federal tax liability of the deceased is approximately</b>	
<b><math>\\$1,000,000 \times .50 \times .28</math> Federal tax rate = \$140,000</b>	<b>\$140,000</b>
<b>(B) To the estate of the deceased shareholder</b>	
Sale proceeds – on sale to survivor	\$1,000,000
ACB of shares	\$1,000,000
Capital gain	nil
<b>Net after tax value to the estate</b>	<b>\$860,000</b>
<b>(C) To the surviving shareholder</b>	
Total value of shares now owned by survivor	\$2,000,000
ACB of original shares	nil
ACB of shares acquired from deceased	\$1,000,000
Total ACB for surviving shareholder	\$1,000,000
<b>Latent capital gain</b>	<b>\$1,000,000</b>

\* Under the corporate-owned criss-cross method, the calculation of the amount of life insurance needed to cover the buy-out could be different because the ACB of the policy might be higher than zero. Then, an amount equal to this ACB will flow out of the company as a taxable dividend for the recipient shareholder and increase his tax burden on this portion of the buy-out.

# Appendix C

## *Corporate redemption method*

The following two charts illustrate the tax treatment for the corporate redemption method of structuring a life insurance funding arrangement.

The example below reflects the facts outlined in Appendix B.

Pre stop-loss tax consequences	
(A) To the deceased shareholder	
Deemed proceeds at FMV	\$1,000,000
ACB of shares	nil
Capital gain	\$1,000,000
(B) On redemption from the estate	
Deemed proceeds at FMV	\$1,000,000
Capital dividend elected	(\$1,000,000)
Proceeds of disposition	nil
ACB of shares	\$1,000,000
Capital loss to estate	(\$1,000,000)
Capital loss – to be carried back	(\$1,000,000)
Capital gain to deceased	nil
<b>Net after tax return to the estate</b>	<b>\$1,000,000</b>

## Post stop-loss tax consequences

(A) To the deceased shareholder	
Deemed proceeds at FMV	\$1,000,000
ACB of shares	nil
Capital gain	\$1,000,000
Federal tax payable by deceased	
Net loss carried-back from the estate	(\$500,000)
Net capital gain	\$500,000
Taxable capital gain 50 per cent	\$250,000
<b>Federal tax at 28 per cent</b>	<b>\$70,000</b>
(B) On redemption from the estate	
Deemed proceeds at FMV	\$1,000,000
Capital dividend elected	(\$1,000,000)
Proceeds of disposition	nil
ACB of shares	\$1,000,000
Capital loss to be carried back	(\$1,000,000)
Subsection 112(3.2) loss reduction	\$500,000
<b>Federal tax payable by estate</b>	<b>nil</b>
<b>Total Federal tax payable</b>	<b>\$70,000</b>
<b>Net after tax return to the estate</b>	<b>\$930,000</b>

In all cases involving share redemptions – pre or post stop-loss rules implementation, the ACB of the shares held by the surviving owners is not increased. As a result, the capital gains tax liability is not eliminated, but simply deferred.

(C) Surviving shareholder	
Total FMV of the shares after redemption	\$2,000,000
ACB	nil
Latent capital gain	\$2,000,000

# Appendix D

## Post stop-loss tax consequences with 50 per cent solution

The example below reflects the facts outlined in Appendix B.

<b>(A) To the deceased shareholder</b>	
Deemed proceeds at FMV	\$1,000,000
ACB of shares	nil
Capital gain	\$1,000,000
<b>(B) On redemption from the estate</b>	
Redemption proceeds	\$1,000,000
Less: deemed dividend	\$1,000,000
Proceeds of disposition	nil
Less ACB to estate	\$1,000,000
Capital loss to estate	(\$1,000,000)
Subsection 112(3.2) stop loss reduction	nil
Adjusted capital loss to estate	(\$1,000,000)
Capital loss carryback	(\$1,000,000)
Capital gain to deceased	nil
<b>Federal tax payable by deceased</b>	<b>nil</b>
<b>Federal tax payable by estate</b>	
Deemed dividend received on redemption	\$1,000,000
Capital dividend elected	\$500,000
Taxable dividend	\$500,000
Dividend gross-up 25 per cent	\$125,000
Dividend subject to tax	\$625,000
Federal tax at 28 per cent	\$175,000
Less dividend tax credit	\$83,340
Federal tax payable	\$91,660
Total Federal tax payable	\$91,660
<b>Net value to the estate</b>	<b>\$908,340</b>
<b>(C) Surviving shareholder</b>	
Total FMV of the shares after redemption	\$2,000,000
ABC	nil
Latent capital gain	\$2,000,000

# Appendix E

## Comparison of tax consequences for 50 per cent capital dividend versus 100 per cent capital dividend

The example below reflects the facts outlined in Appendix B.

### Post stop-loss tax consequences with 100 per cent capital dividend pay out to estate

(A) Deceased shareholder	
Federal tax on capital gain – 50 per cent x 500,000 x 28 per cent	\$70,000
(B) Estate	
Tax on capital gain	nil
Tax on deemed dividend	nil
Net value	\$930,000
(C) Surviving shareholder	
FMV of shares	\$2,000,000
ACB	nil
Latent capital gain	\$2,000,000
Additional value after redemption	\$1,000,000
Increase in ACB	nil
Taxable capital gain on additional value	\$500,000
Federal tax payable at 28 per cent	\$140,000
Loss of Capital Dividend Account credits	\$500,000
Dividend gross-up 25 per cent	\$125,000
Dividend subject to tax	\$625,000
Federal tax at 28 per cent	\$175,000
Less dividend tax credit	\$83,340
Federal tax on dividend	\$91,660
Additional tax burden	\$231,660
<b>Federal tax</b>	<b>\$231,660</b>
<b>Total Federal tax burden</b>	<b>\$301,660</b>

### Post stop-loss tax consequences with 50 per cent capital dividend pay out to estate

(A) Deceased shareholder	
Federal tax on capital gain	nil
(B) Estate	
Tax on capital gain	nil
Tax on deemed dividend	\$91,660
Net value	\$908,340
(C) Surviving shareholder	
FMV of shares	\$2,000,000
ACB	nil
Latent capital gain	\$2,000,000
Additional value after redemption	\$1,000,000
ACB of the new shares	nil
Taxable capital gain on additional value	\$500,000
Federal tax payable at 28 per cent	\$140,000
Additional CDA credits	\$500,000
Loss of CDA credits	nil
Additional Federal tax burden	\$140,000
<b>Total Federal tax burden</b>	<b>\$231,660</b>

Looking at the arrangement as a whole, the 50 per cent solution means a total tax savings of \$70,000, although the estate assumes \$21,660 in additional tax. Furthermore, the additional \$140,000 Federal tax payable on the surviving shareholder's capital gain is not a real additional tax burden as it is part of his latent capital gain in any event.

# Appendix F

## *Redeem and cross-purchase arrangement*

The example below reflects the facts outlined in Appendix B.

<b>(A) Deceased shareholder</b>	
Deemed proceeds at FMV	\$1,000,000
ACB of the shares	nil
Capital gain	\$1,000,000
Estate capital loss carry-back	(\$250,000)
Net capital gain	\$750,000
Taxable capital gain 50 per cent	\$375,000
<b>Federal tax payable at 28 per cent</b>	<b>105,000</b>
<b>(B) Estate</b>	
Share redemptions proceeds 50 per cent	\$500,000
Less deemed capital dividend	(\$500,000)
Proceeds of disposition	nil
Less ACB to estate	(\$500,000)
Capital loss to estate	\$500,000
Subsection 112(3.2) stop-loss reduction	(\$250,000)
Capital loss carry-back	\$250,000
Subsection 83(2) elected deemed	
Capital dividend to estate	\$500,000
New shares proceeds at FMV	\$500,000
Less ACB to estate	(\$500,000)
Capital gain	nil
Disposition of share proceeds to estate	\$500,000
Tax on capital gain	nil
Tax on deemed dividend	nil
<b>Net value after tax on the deceased's capital gain</b>	<b>\$895,000</b>
<b>(C) Surviving shareholder</b>	
FMV of shares	\$2,000,000
ACB of the shares	(\$500,000)
Total capital gain	\$1,500,000
Additional value after redemption	\$1,000,000
ACB of the new shares after buy-out	\$500,000
Taxable capital gain on additional value	\$250,000
<b>Federal tax payable at 28 per cent</b>	<b>\$70,000</b>
<b>Total Federal tax on latent capital gain at 28 per cent</b>	<b>\$210,000</b>
<b>Total Federal tax burden</b>	<b>\$315,000</b>

If the deceased owner can take advantage of the \$500,000 qualified small business shares capital gain exemption, the overall Federal tax burden will reduce to \$105,000. It means \$35,000 in tax payable on the capital gain for the deceased and a net after-tax cash flow for the estate of \$965,000.

For more information about any Sun Life Financial products – call **1 800 SUN-LIFE / 1 800 786-5433** or visit our Web site at [www.sunlife.ca](http://www.sunlife.ca).

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