Funding solutions for buy-sell agreements

Evaluating your options

by Diane Dupuis

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Congratulations! After years of hard work and determination, your business has finally become the company you dreamed it could be! The future looks bright - sales are growing, operations are expanding and your employees are happy and productive. You've even constructed a buy-sell agreement to protect the continuity of the business in the event of an owner or partner's death. The question is, have you arranged for proper funding for this buy-sell agreement?

Unfortunately, many Canadian business owners overlook this important aspect of their succession plan, putting their plan into jeopardy. So if you haven't taken the time to arrange funding for your succession plan, consider these options:

Tap into company capital

One way to fund a buy-sell agreement is to tap into the company's current or future working capital. The downside of this strategy is that it can create serious financial implications. Cash flow may be strained, day-to-day functions may be restricted, and credit issues with lenders or suppliers may arise. Using existing capital to fund a buy-sell agreement is a costly option since non-deductible, after-tax dollars are used to purchase the outstanding business interest. In addition, if the company falls on hard times, this source of income could easily dry up.

Establish a sinking fund

A sinking fund is similar to an emergency fund: it's a source of capital the company (or business owners) creates over time to cover the death of an owner or partner. While it may take several years to build sufficient resources to manage such a financial challenge, death may occur at any time, making this option a less-than-ideal strategy. Another drawback of a sinking fund is that it's an expensive way to fund a buy-sell agreement because deposits are made with personal or business after-tax dollars. Keep in mind, similar to the above example, using working capital for this purpose may impose financial restrictions on the company.

Borrow money

Another way to fund a buy-sell agreement is to borrow the funds. Unfortunately, a lending institution may not lend your company the necessary funds given its vulnerable position so don't rely on this option. If, however, your company managed to secure a loan, it's important to note that you would be paying more to purchase the deceased owner's shares. How much more would depend on the interest rate and term of the loan.

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Use life insurance proceeds

Purchasing life insurance is the most economical way to ensure your company has a ready source of funds just when it's needed most. (Since life insurance proceeds are tax-free, this option becomes even more appealing.) Having a plan in place allows the company to purchase the deceased business owner's interest without putting a financial strain on operations. Cash accumulations built inside universal life plans for example can also be used to supplement significant financial events such as your retirement. In addition, the wide variety of plans and options allow you to customize a plan to fulfill your company's budget and goals.

There are several ways to fund a buy-sell agreement, but for most, life insurance is the best way to go. Talk to your financial advisor today to review your options.

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