5 common mistakes to avoid when drafting a shareholders’ agreement

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If you own shares in a private corporation you should be no stranger to a shareholder’s agreement. This document, which outlines how the company should be operated and the rights and responsibilities of the shareholders, is integral in protecting your rights as a stakeholder in the business. You may also be aware that there are significant benefits in funding your shareholder’s agreement with life insurance. If done successfully, there is ample opportunity to create positive ownership/beneficiary arrangements and buy-out provisions. As in all documents of this nature, however, there is always a potential for error. The following are 5 common errors and omissions to avoid when you are drafting your shareholder’s agreement with your life insurance advisor.

Lack of Tax Planning
Tax rules change regularly and it can often be expensive to incur additional professional fees to revise your agreement after every change in legislation. While your insurance advisor is not likely to provide you with direct tax advice, it is important that they are well-versed in the importance of tax and its applications to life insurance.

No Reference to Capital Dividend Account (CDA)
The CDA is a focal point for planning when a shareholder’s agreement is funded with corporate owned life insurance. This account is a notional tax account and is used to pass tax-free funds to shareholders as dividends. When drafting your agreement it is important to include a clause regarding the payment of the capital dividend. If it is not mentioned there is no requirement that it will have to be paid, and no guarantee that you will receive your expected tax benefits.

Optional Buyouts
Except in unusual circumstances, the purchase and sales of shares on a shareholder’s death should be mandatory. An optional buyout may seem appealing for surviving shareholders and the company in general, but a lack of clear direction often causes more anxiety than it solves. The future of your business could be put at risk while the disposition of the deceased’s shares is contemplated.

Inaccurately Defining “Disabled”
In a case where disability buyout insurance is in place, insurance policies are used to determine whether or not a person is disabled, or in other words, whether or not they can benefit from the agreement. Referring to both physical and mental incapacity, and providing a sufficient waiting period to determine the extent of the disability are proactive steps towards drafting an effective shareholder’s agreement.

Wrongly Determining the Ownership of a Policy
Making an operating company the owner and beneficiary of a life insurance policy is not always ideal. Corporate-owned policies can be subject to corporation creditors and life insurance policies are not considered active business assets for the purpose of the capital gains exemption. In other words, the tax benefits can be less ideal when the policy is corporately owned.

Speak with your advisor to discover what works best for you.