

Buy-Sell Agreements are as Important as Wills for Family Farms

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Most business owners are concerned about what will happen to the business and their heirs at their death. One of the best ways to keep the farm or ranch operation from falling apart when one of the owners dies is to create a market for the assets before death. This can be done through a binding buy-sell agreement.

In a family-owned business, a buy-sell agreement may also be used to assure business continuity within the family or to prevent ownership from passing outside the family without the consent of the other family members.

Another problem which can be avoided by using a funded buy-sell agreement involves the situation where one child has remained on the farm to run the business but has two or more off-farm siblings. If the farm is left to the children equally, the one operating the farm

1. Becomes a minority owner,
2. May attempt to buy out the others and take on more debt than he can service, or
3. Is forced to deal with strained family relationships if the off-farm heirs become dissatisfied with the income they receive relative to the value of their assets. Off-farm heirs may feel the sibling operating the farm is managing the business improperly or receiving a disproportionate share of the benefits.

A buy-sell agreement should protect all of the heirs. The problem is obtaining an adequate price for the farm assets. For sole proprietorships, where both personal and business assets are held in the owner's name, the agreement should specifically state and clearly define all of the assets to be included in the sale.

If the business is a partnership, the death of a partner normally has the effect of legally dissolving the partnership. When a partner dies, the partnership must either be liquidated or reorganized. To avoid liquidations, the surviving partners and the heirs of the deceased partner must attempt to arrive at a mutually satisfactory plan to reorganize the firm and continue the business. There are at least four possible forms of reorganization which they may consider:

1. Take in the heirs as partners.
2. Take in someone who purchases the heirs' interest.
3. Buy out the interest of the heirs.
4. Sell out to the heirs.

The best alternative is to enter into a suitable agreement *before* the death of any partner, to avoid liquidation and determine beforehand the form of reorganization mutually agreeable to the partners.

A buy-sell agreement offers numerous advantages to both the surviving partner and the deceased partner's estate. To the surviving partners, the advantages include the following:

- Because there is a prior agreement, forced liquidation, with its potentially undesirable consequences, does not occur.
- Reorganization is automatic. The partnership is given continuity of existence that otherwise would be impossible.
- The survivors are not forced to accept an undesirable reorganization plan, such as a new partnership with an unacceptable partner. The business insurance plan also removes the possibility that outsiders, such as a deceased partner's widow's second husband, might someday be involved.
- A price acceptable to all partners is written into a contract, guaranteeing a sale.

A buy-sell agreement's beneficial results for the deceased partner's estate include the following:

- The widow, as well as each partner, is assured that she will receive a full and fair price for her husband's interest. Further, it will be paid immediately and in cash, eliminating the necessity to look elsewhere for needed dollars.
- Cash replaces the relatively nonliquid partnership interest. The estate can be settled more quickly and, as a result, more economically.

For corporations the buy-sell agreement is very similar to that of a partnership, except that it is set up among the shareholders or between the shareholders and the corporation,

There are two basic types of buy-sell agreements. They are the cross-purchase plan and the entity plan. A combination of both types of agreement may be used.

If the surviving partners, shareholders, or other heirs are to be purchasers, a cross-purchase plan should be used. This is an agreement between two or more partners, shareholders, or individuals stating that if one of them dies, the survivors will purchase his business interest.

The entity plan is an agreement between the business and the partners or shareholders individually. It is agreed that, if a partner/shareholder dies, the business entity will purchase his business interest on behalf of the surviving partners or shareholders.

One means of funding a buy-sell agreement may be installment payment of the purchase price. This procedure not only relieves the business entity and surviving heirs, shareholders, or partners of the necessity of immediately obtaining funds for the purchase of deceased party's interest, but may offer income tax advantages to the estate of the deceased, provided the arrangement complies with all IRS requirements relating to installment sales. Naturally, such arrangement involve some risk and uncertainty, in that the business entity or individual purchasers might default on the obligation.

Another popular means of funding a buy-sell agreement is through life insurance contracts. With life insurance as the funding vehicle, sufficient cash is available when death occurs. The purchase price will not have to come from personal assets or from annual profits.

In sole proprietorship situation, a life insurance policy would be held on the life of the farm or rancher operator, with others as the owners of the policy and payers of all premiums. At the death of the farm/ranch operators, the beneficiary will collect the insurance proceeds free of income tax. In this way, the son, daughter, or other person obtains the capital required to purchase the farm, and the binding buy-sell agreement takes precedence over any will. The executor for the farmer's estate gives the successor(s) the deed to the land and other assets, and uses the insurance proceeds to pay the estate for the farm.

Usually, if there are only two partner/shareholders in a cross purchase plan, each partner/shareholder purchases a policy on the life of the other partner/shareholder. Each partner/shareholder is owner and beneficiary of the policy for which he applies. Also, he pays the premiums on that policy.

If there are more than two partners or shareholders, it may become a

little more complex since each partner/shareholder would own policies on each of the other partner/shareholders. For a partnership or corporation with three partner/shareholders, there could be six policies outstanding.

The life insurance industry has recognized the problems that can occur with several individuals being involved in business entities by creating a new product called “first -to-die.” This involves only one policy, covering the lives of all the shareholders or partners. The policy provides funds at the death of the first partner/shareholder to die. Since more than one life is being covered, it may be possible for individuals who could not get an individual policy due to age or health condition to still be covered.

In an entity purchase plan, the business entity applies for a policy on the life of each partner or shareholder for the full amount of the purchase price, or for whatever portion is being insured. The entity is also owner, beneficiary, and premium payer of the policies.

Since the successor heirs may have problem paying the insurance premiums in cross-purchase agreements, it may be necessary to either increase their salaries, increase their share of the profits, or have the “owners” gift or loan the premiums to the business successors. This is imperative for several reasons, including:

1. The insurance and the buy-sell agreement assure the deceased partner/shareholder and his heirs that they will receive a full fair price for the farm business in cash....not just promissory notes.
2. This plan can help tie the operation’s key successors to the farm or ranch business. Therefore, they will not be as likely to leave at a critical time.
3. These successors will have a personal interest and incentive to do more for the farm business. This can lead to improved performance, which can help justify the increase in salary.
4. This plan will guarantee the continuance of the farm as a “going concern.”
5. The salary increase will afford all of these advantages with “tax advantaged” dollars, because the business can deduct the salary increase as a business expense for income tax purposes.

Typically, buy-sell agreements include an agreed-upon price for the

purchase of the assets of the deceased individual. In other situations the price may be determined either by an appraisal following the farmers's death or by some formula included in the agreement. Such provisions must be reviewed and updated regularly to be fair to all parties. Any formula fo calculating the sale price must represent the fair market value at the time the agreement is drawn. Fair market value is the price a willing buyer would pay a willing seller in a free market for the property being sold. If the agreement is made at arm's length, it will usually reflect fair market value. If the price is fair at the time the agreement in entered into, it will be a factor that can control the valuation for federal estate tax purposes, even is there has been a rise in the farm value since the agreement was executed.

A buy-sell agreement provides that if a partner, shareholder, or individual proprietor wished to sell out during his lifetime, the agreement must bind each individual to offer his interest to the other business owners before disposing of it elsewhere. The price determination that applies at a member's death also applies during life. This provision puts teeth into the agreement.

Federal tax considerations are always important when farmers and ranchers make financial decisions. Final decisions in this area must be made by the parties themselves, afer they consult their attorneys and tax preparer.