Intergenerational Transfer of the Farm/Ranch Business - The Buy-Sell Agreement

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April 2022
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
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Overview

For many farm and ranch family operations, a buy-sell agreement may be just about as important as a properly drafted will or trust. This is particularly the case when the goal is to transition the business to a subsequent generation of owners and operators. Typically funded by life insurance to make them operational, the type of buy-sell utilized, and the drafting of the buy-sell are fundamentally associated with their ability to accomplish succession planning objectives.

Basic pointers on buy-sell agreements – it's the topic of today's post.

In General

The traditional buy-sell agreement is designed to provide protection to business co-owners in the event an owner departs. The agreement allows the continuing owners to acquire the interest of the departing owner in a way that the departing owner (and heirs) are no longer part of the business.

A buy-sell agreement can also be designed to fund the retirement of the founding generation and/or consolidate ownership among the heirs that are to be the next generation owners/operators. It can also be designed such that cash flows into the hands of the non-managerial heirs. In any event, the agreement must be tailored to the facts of each situation and drafted in coordination with the estate plans of the senior generation. Those estate plans could be complex, including the payment of federal estate tax in installments and special use valuation. Those techniques have qualification requirements that must be satisfied post-death. A buy-sell agreement must not complicate satisfying those qualification requirements.

When considering the use of a buy-sell agreement, there are some fundamental questions that must be answered.

- What should the method of the buy-out be? Will the farming/ranching entity redeem the departing owner's interest, or will the remaining owner's do it?
- What triggers the buy-out? Death is an obvious event that triggers a buy-out, but what about the retirement or disability of an owner?
- How will the buy-out agreement be funded?

The resolution of these questions will depend upon the type of entity structure involved and the estate planning and intergenerational transfer goals of the senior owners.

Type of Buy-Sell Agreements

Buy-sell agreements are generally of three types:

1. Redemption agreements (a.k.a. entity purchase). This type of agreement is a contract between the owners of the business and the business whereby each owner agrees to sell his interest to the business upon the occurrence of certain events.

1. Cross-purchase agreements. This type of agreement is a contract between or among the owners (the business is not necessarily a party to the agreement) whereby each owner agrees to sell his shares to the other owners on the occurrence of specified events.

2. Hybrid agreements. This type of agreement is a contract between the business and the owners whereby the owners agree to offer their shares first to the corporation and then to the other owners on the occurrence of certain events.

Income Tax Consequences for C Corporation Buy-Outs

For redemption agreements, if I.R.C. §§302(b)-303 are not satisfied, the redemption is taxed as a dividend distribution (ordinary income without recovery of basis) to the extent of the stockholder's allocable portion of current and accumulated earnings and profits, without regard to the stockholder's basis in his shares. This can be a significant problem for post-mortem redemptions - the estate of a deceased shareholder would normally receive a basis in the shares equal to their value on the date of death or the alternate valuation date. Thus, dividend treatment can result in the recognition of the entire purchase price as ordinary income to a redeemed estate, whereas sale or exchange treatment results in recognition of no taxable gain whatsoever.

For cross-purchase agreements, unless the shareholder is a dealer in stock, any gain on the sale is a capital gain regardless of the character of the corporation's underlying assets. *I.R.C. §1221.* For the estate that sells the stock shortly after the shareholder's death, no gain is recognized if the agreement sets the sale price at the date of death value. *I.R.C. §§1014; 2032.* The purchasing shareholders increase their basis in their total holdings of corporate stock by the price paid for the shares purchased under the agreement, even if the shares are paid for with tax-free life insurance proceeds.

Note: If an S election is in place, the corporate income is taxed to the shareholders and can be withdrawn from the corporation to fund a cross-purchase agreement without triggering additional tax. If the triggering event is something other than death, a cross-purchase agreement is required to achieve an increased cost basis to the purchasing shareholder(s).

A hybrid agreement requires the corporation to redeem only as much stock as will qualify for sale or exchange treatment under I.R.C. §303, and then requires the other shareholders to buy the balance of the available stock. This permits the corporation to finance part of the purchase price, to the extent required to pay estate taxes and expenses and assures sale or exchange treatment on the entire transaction. *I.R.C. §303(b)(3).*

Under a "wait and see" type of buy-sell agreement, the identity of the purchaser is not disclosed until the actual time of purchase as triggered in the agreement. The corporation will have first shot at purchasing shares, then the remaining shareholders, then the corporation may be obligated to buy any remaining shares.

Alternative Approaches

The corporation could buy a life insurance policy on the life of each stockholder, with the corporation as the policy owner, premium payer, and beneficiary of these policies. The corporation could then use the life insurance to finance the purchase if, at the end of the first option period, the corporation buys the deceased stockholder's interest. The corporation could lend the insurance proceeds to the stockholders if, at the end of the corporate option period, it is decided that the surviving stockholders should be the buyers (or to the extent stock remained to be purchased after the corporation's option expires). Investment payments would be deductible to the stockholders and income to the corporation.

An alternative approach is for each shareholder to buy, pay for, own, and be the beneficiary of a life insurance policy for each of the other shareholders. The surviving shareholders would then receive the proceeds when one shareholder dies, and, if a cross-purchase is indicated and appropriate, use the proceeds as the necessary funds to carry out the buy-sell agreement. The surviving shareholders could also lend the proceeds to the corporation if an entity purchase agreement is utilized, to enable the corporation to buy additional shares, or the surviving shareholders could make capital contributions which would have the effect of increasing each shareholder's stock basis.

A combination of the above approaches could also be used for funding the wait-and-see buy-sell agreement. For example, the corporation could own cash value life insurance and the owners could own term insurance. Also, the parties could have a split-dollar arrangement whereby the corporation pays for the cash value portion of the premiums and the shareholders own the policy and pay for the term portion of the premiums, with the proceeds split between them.

A buy-sell agreement that imposes employment-related restrictions may create ordinary compensation income (without recovery of basis). *I.R.C. §83.* However, an agreement containing transfer restrictions that are sufficient to render the stock substantially non-vested (substantial risk of forfeiture) may prevent the current recognition of ordinary income.

Advantages and Disadvantages Of Buy-Sell Agreements

Pros. A well-drafted buy-sell agreement is designed to prevent the sale (or other transfer) of business interests outside the family unit. In general, a buy-sell agreement is a relatively simple agreement. It is a contract between family members. There are few formalities to follow under state law, and no filing or registration fees. It also creates a ready market for an owner's interest, easing the liquidity problems created by the ownership of a block of closely-held business interests at the owner's death. In addition, if the buy-sell is drafted properly, it can help establish the value of the business interests if drafted properly.

Cons. On the downside, a hybrid or redemption type of buy-sell agreement may not yield favorable tax consequences upon the purchase of business interests in accordance with the agreement. This is typically not a problem with a cross-purchase agreement. The basic problem is that a corporate distribution in a redemption of stock is taxed as a dividend (i.e., taxed as ordinary income to the extent of earnings and profits, without recovery of basis), unless it meets the technical requirements of I.R.C. §302(b) or §303.

As discussed further below, the parties to the agreement must have funds available to buy the stock at the time the agreement is triggered. Typically, life insurance is purchased for each business owner to cover the total purchase price (or at least the down payment). However, the premiums on such policies are not deductible (*see I.R.C. §264)* and can create a substantial ongoing expense.

Estate Planning Implications

The purchase of a deceased shareholder's stock can deprive the estate of the advantage of certain post-mortem estate planning techniques such as special use valuation and installment payment of federal estate tax under. As for the installment payment provision, the sale of all or a substantial part of the shares during the deferral period accelerates the deferred taxes. *I.R.C. §6166 (g)(1)(B).* Thus, it may be a good strategy to plan a series of redemptions or purchases in amounts equal to the taxes that must be paid in each of the fifteen years of the deferral period.

If a buy-sell is not planned well, the agreement can cause a gift of stock to a trust for the surviving spouse not to qualify for the estate tax marital deduction. In *Estate of Rinaldi v. United States, 38 Fed. Cl. 341 (1997), aff'd., 178 F.3d 1308 (Fed. Cir. 1998), cert. den., 526 U.S. 1006 (1999),* a purchase option was created in the decedent's will for a son that was named as trustee of a QTIP trust for the decedent's surviving spouse. The court determined that the marital deduction was not available because the son could purchase the stock at book value by ceasing active management in the company. That result would have been the same had the option been included in an independent buy-sell agreement.

Funding

Life insurance is often the preferred means of funding the testamentary purchases of stock pursuant to a buy-sell agreement because the death benefit is financed by a series of smaller premium payments, and because the proceeds are received by the beneficiary without income tax liability. *See I.R.C. §101.* But, there can be traps associated with life insurance funding. For instance, proceeds received by a C corporation can increase the corporation's AMT liability by increasing its adjusted current earnings (even if the proceeds are to be used to redeem the stockholder's shares). *See IRC §56(g).* Also, life insurance may be sufficient to fund the buyout of a deceased owner's interest, but may be insufficient to fund the lifetime redemption occasioned by the owner's disability or retirement.

Other observations. The cash value of a permanent life insurance policy may be withdrawn by loan or surrender of the policy, but the value may be a very small percentage of the death benefit, inadequate to finance the buy-out. Disability insurance may be used to finance a purchase occasioned by an owner's disability, but it can be quite expensive, and cannot be applied toward the purchase of an interest of an owner who is retiring or used to prevent the sale of an interest in the business to a buyer outside the family unit.

It is possible to use accumulated earnings of the business to fund a redemption. But, such a strategy may not be treated as a "reasonable need of the business" with the result that the business (if it is a C corporation) could be subject to the accumulated earnings tax. *I.R.C. §531*. However, corporate accumulations used to pay off a note given a stockholder for a redemption is a reasonable need of the business, as a debt retirement cost. *But see Smoot Sand & Gravel Corp. v. Comr., 274 F.2d 495 (4th Cir. 1960), cert. denied, 362 U.S. 976 (1960).*

Conclusion

A well-drafted buy sell agreement can be a very useful document to assist in the transitioning of a family business from one generation to the next. It can also be a useful device for assisting in balancing out inheritances among heirs by making sure the heirs interested in running the family business end up with control of the business and other heirs end up with non-control interests. In any event, a sound buy-sell agreement is a critical part of many family business succession plans.

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