



Estate Planning Considerations for Ohio Families

Section 5

40 Estate Planning Tools

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Agricultural Easements

An agricultural easement is a voluntary legal restriction that limits a property's uses to agricultural activities. A landowner may enter into a Deed of Agricultural Easement with a legally authorized easement "holder," which may be the State of Ohio, a county, township, municipality, or land trust. The Deed of Agricultural Easement forfeits the owner's right to develop the property for non-agricultural uses, and allows the holder to enforce the restriction at law.

In Ohio, a property owner may donate an agricultural easement or may qualify for the Ohio Agricultural Easement Purchase Program and receive a payment for an agricultural easement. Under either scenario, the landowner can utilize an agricultural easement for several estate planning purposes: to protect the land for future generations, to lower the value of the land, and to receive income and/or estate tax benefits.

For example, the restriction resulting from an agricultural easement can lower the fair market value of the property, thereby lowering its value for estate transfer or estate tax purposes. A donated agricultural easement might also qualify as a charitable contribution under the Internal Revenue Code, the result of which is a federal income tax deduction. Proceeds from the sale of an agricultural easement can be utilized to lower debt ratios or to acquire additional property under a like-kind exchange. As with any estate planning tool, it is important to consult legal and tax advisors to understand the implications of an agricultural easement for a particular estate.

Conservation Easements

If properly structured, a conservation easement can create several benefits. First, if you give up an easement to a qualified charitable organization or the government, you may obtain a charitable income tax deduction for the value of the easement. Second, the value of the real estate in your estate for estate tax purposes will be valued at a lower value because it is subject to the easement.

In addition, an executor may elect to exclude from the taxable estate up to 40 percent of the value of any

land subject to a qualified conservation easement meeting certain requirements. The amount is subject to a dollar limit of \$500,000 in 2002 and later. It also may be further reduced if the value of the easement in proportion to the overall value of the property is small.

This exclusion can apply to landowners who had earlier granted a qualified conservation contribution of a qualified real property interest or to easements granted by the executor if properly authorized in a will. Although, there is no income tax deduction for easements granted after death. For dates of death after 2010, the land must be within 25 miles of a metropolitan area or within 10 miles of an urban national forest. The metropolitan areas are defined by county, so most of Ohio, if not all, is within 25 miles of a metropolitan area. In addition, the land must have been owned by the decedent or a member of the decedent's family within three years of death. Preplanning is necessary to meet these and other rules in order to qualify for this exclusion. The relatively new agricultural easements in Ohio may qualify for these benefits if properly structured.

Annuity

Commercial Annuities

An annuity is the annual payment of an allowance or income. Commercial annuities are usually issued by an insurance company, charity, or investment company. A person may give an insurance company a fixed sum of money in exchange for which the insurance company promises to give the person payments of a given amount for as long as they live. Or the contract could call for the payment of a given amount for as long as the person and the person's spouse live. Obviously the financial soundness of the company that promises to make the annuity payments is an important consideration when entering into such an agreement.

Similarly, a person may have invested a sum of money with an investment company. The investment company may take over the investment in exchange for promising to pay the person a fixed sum of money for their life or for their life and their spouse's life. Some advantages of the commercial annuity are the fact that when the last person dies it has a zero value in the estate, it provides a reasonably assured income for as long as the person(s) live(s), and it spreads the income tax liability, if any, for cashing in the annuity over the person's lifetime.

A charity also may give someone an annuity in exchange for the person(s) giving property to the charity. This offers the additional benefit of an itemized deduction on the income tax return. For more information on Charitable Remainder Trusts see Section 4.

For more information about commercial annuities visit <http://www.ohioinsurance.gov/consumserv/ocs/ocspub.htm> then click on Shopper's Guide to Annuities.

Private Annuities

A private annuity is an agreement between individuals, frequently family members. In a typical scenario the parents transfer their farm to a child in exchange for the child agreeing to make annuity payments for as long as the parent(s) live. If the annuity payments are set up to reflect an "arms length" transaction, this effectively removes the farm from the parent's estate(s). However, a portion of each payment received by the parent(s) is taxable, just like payments on an installment sale.

While appearing simple and straightforward, private annuities can lead to any number of problems. From the parent's perspective, a major problem is that they become an *unsecured* creditor of their child. If they perfect a security interest they usually must pay tax on all the gain on the transfer, if any, in the year of

transfer. Thus, if their child has financial problems they may never get paid. Similarly, if the child dies before the parent it may be difficult for the child's heirs to make payments.

Also, the private annuity always seems to treat someone unfairly. If the parent(s) die too soon, the child buying the property gets a bargain and other children may feel slighted. If the parent(s) live too long the child who is buying the property pays too much.

If the payments do not reflect what they would be in an "arms length" transaction (i.e., they are too low) the parent(s) will have made a gift to the children. While they appear attractive, private annuities are subject to a number of pitfalls. Persons considering them should seek out and use competent counsel before entering into an annuity agreement.

Buy/Sell Agreements

Tax time stimulates many farm owners to consider estate planning and the long-term future of their farm businesses. One of the much-needed issues for many small businesses is the plan to continue the business if one of the owners should unexpectedly leave the business. A carefully drafted Buy/Sell agreement can help with this process.

A Buy/Sell agreement is an arrangement between two or more parties that obligates one party to buy the business and another party to sell the business upon the death, disability, or retirement of one of the owners. The agreement is designed to cause a smooth transition following the departure of a business owner. It allows the owners to consider how they want their business to proceed under a variety of circumstances.

Death, disability, and retirement are normally thought of as a triggering event for a Buy/Sell agreement. However, a Buy/Sell agreement also may be triggered by a third-party offer to purchase, divorce, a creditor's judgment, bankruptcy, or termination. Some eventualities can be provided for with insurance, others cannot.

The process of developing a Buy/Sell agreement is usually initiated by the business owner(s) at the suggestion of family members, an attorney, accountant, life insurance agent, or lender. One or all may be concerned about the potential business continuation problems and will suggest a Buy/Sell agreement as part of a business and estate plan. The choice of professionals to help set up an agreement is crucial to its ultimate success.

The usual purposes of the Buy/Sell agreement are:

1. To ensure that the ownership and control of the firm remains within the family and perhaps certain employees.
2. To provide someone to buy when owners of the business or their heirs need to sell.
3. To establish a fair value for the interest in the firm.
4. To provide funding mechanisms or payment terms and conditions for the purchase of an interest in the business.

There are several different kinds of Buy/Sell agreements and some of them have several names. The type of Buy/Sell agreement used by a business depends on many factors including:

- the number of owners,
- owners' ages,
- interest owned by each owner,

- the money available to create it and keep it in force,
- and the tax brackets of the owner and the business.

Cross Purchase Agreements

One of the more common types of Buy/Sell Agreements is the “Cross Purchase Agreement,” under which each business owner buys life insurance on the lives of the other owners. When a death occurs, the policy owners are obligated under their agreement to use the proceeds from the life insurance to purchase the business interests of the deceased from the deceased’s heirs.

The Cross Purchase Agreement works best in companies with a few young owners because the number of life insurance policies and their cost become a problem when there are more than two or three owners or several owners are near retirement age or have significant health problems. Also, younger owners pay a much higher premium for insurance on an older, health rated, partner than the older owner pays to insure a young healthy owner. The individual owners bear the expense, which is not a tax deductible expense.

Some companies use Split Dollar Funding where the business pays part or all of the cost of the life insurance. This reduces the personal cost to the individual owners and lets the business show the cash value of the policy as an asset on its financial statement. If the decedent dies while the policy is in effect, the business recovers what it paid in premiums. However, if the policy is in effect many years the business will get most of the insurance proceeds and the remainder may not be adequate to make the required purchase.

Entity Purchase Agreement

Under an “Entity Purchase Agreement” the business itself is obligated to purchase the ownership of a deceased or leaving owner. Frequently these are at least partially funded by the firm buying life insurance policies on each of the owners. Having the firm buy the policies reduces the number of life insurance policies needed as compared to the Cross Purchase Agreement, and the company bears the expense rather than the individuals. However, the results at an owner’s death tend to favor remaining owners over the heirs of the deceased, unless the business owners frequently revalue the company at fair market value.

Other Buy/Sell Agreements

Buy/Sell agreements have been designed to meet many different family and business needs. The possibilities are only limited by the imagination and the ability of the business and family to fund them. For example, under a “No-sell, Buy/Sell Agreement” the remaining owners remain in control of the business and the leaving owner or his or her heirs retain their share in the business, but control of the business remains with the owners who are still in the business. It also may provide some funds to the leaving owner or his or her heirs. The “Wait and See Purchase Agreement” allows the parties to structure the transaction at the time of the triggering event.

Life Insurance Has Limitations

One of the greatest advantages of the use of life insurance in a Buy/Sell agreement is its ability to immediately provide adequate funds for the beneficiary should one of the parties die unexpectedly.

If a business is successful and grows over time, growth and inflation will likely make the original life insurance policies inadequate in 10 to 15 years. While it is possible to initially purchase insurance which can be increased over time, the increase is usually limited and in reality many people do not increase it or take other action to meet the shortfall.

Another concern is the cost of all the life insurance needed to fully fund a Buy/Sell agreement. It is not uncommon for the annual premiums for all the life insurance policies on all the owners of a small business to cost tens of thousands of dollars. When a business is doing well, the business and family members may have no trouble making the premium payments; however, if the business does not do well it may place a considerable burden on the family and business to pay life insurance premiums. For this and other reasons, most life insurance policies are canceled before the insured dies.

There are also differences in the cost of life insurance policies offered by different companies for the same coverage. Prices for insurance can be seen at the Ohio Department of Insurance's website: <http://www.ohioinsurance.gov/consumserv/ocs/ocspub.htm>. Click on Shopper's Guide to Life Insurance, then click on Sample Annual Premiums.

If life insurance is to be a part of the Buy/Sell agreement, time spent comparing policy prices could be time well spent.

In the long-run, most business owners should make arrangements to fund at least part of the Buy/Sell agreement with something besides life insurance. Other likely sources of cash include: investments, liquidation of assets, and payment plans which allow business owners to make payments to the departing business owners or their heirs over time. Business owners also may want to reduce their interest in the business by selling or giving away some of their interest in the business.

Finally, life insurance only provides cash in the case of the death of the insured. It does not provide money due to disability, retirement, divorce, a creditor's judgment, bankruptcy, or termination. One can purchase disability insurance, but for the other possibilities, the owners will need to find non-insurance sources of funds to cover them.

Summing Up

Buy/Sell agreements are important documents that can help in the smooth transfer of a business from one generation to the next. Due to their complexity and the many options available, the choice of professionals to assist with selecting and implementing a Buy/Sell agreement is crucial. Life insurance is a valuable tool for funding a plan, but life insurance has limitations and usually should be supplemented with other funding sources.

Deduction for Qualified Family-Owned Business

Farmers and small business owners may qualify for an additional deduction that can be coupled with the unified credit to permit transfer of up to \$1.3 million per person without federal estate tax. In 1998 legislation, the Qualified Family-Owned Business benefit was changed from an exclusion to a deduction, with a maximum deduction of \$675,000. The effect is still to reduce the decedent's taxable estate, but as a deduction, the qualifying property will receive a stepped up basis as of the date of death. A step-up in basis may be important if the family intends to sell the business in the future. This deduction has now been repealed for years 2004 through 2010. The applicable exclusion amount will remain at \$625,000 for estates electing the Family Owned Business deduction, while the applicable exclusion amount has increased to \$1,000,000 for others not making the election. However, if the estate includes less than \$675,000 of qualified family-owned business assets, the applicable exclusion amount is increased to the maximum allowable for that year. In no case may the total exceed \$1.3 million.

By properly splitting ownership, and with both spouses staying eligible for the family business deduction, their estates could reach a combined level of \$2.6 million in 2002 with no federal estate tax. The small business deduction can also be coupled with special use valuation of farmland (Section 2032A). If all of

the tests can be met for both elections, a couple could exclude a maximum of approximately \$4.2 million in 2002. This is a very important provision as it relates to farm estate planning.

As might be expected, Congress did not provide for the deduction without some strings attached. The rules become quite restrictive. A “qualified family-owned business interest” has its principal place of business in the United States and is owned at least 50% by the decedent and members of his or her family, 70% by two families, or 90% by three families (including the required percentage of all classes of stock, if a corporation). The value of the decedent’s qualified family-owned business interests must be at least 50% of the adjusted gross estate, and must pass to qualified heirs. However, gifts of business interests during lifetime to family members may be considered in calculating the 50% test (valued at date of gift) if the family members continuously own the gifts until the date of death of the person who made the gifts. In addition, the decedent must have been a U.S. citizen or resident and the decedent or a member of his or her family must have owned the business and have materially participated in the business for five of the eight years preceding death, retirement, or disability. Passive investments and excess working capital cannot be considered as part of the business interest for purposes of qualification. A recapture tax is levied if within 10 years of death, a recapture event occurs. This can include absence of material participation for more than three years in eight, sale or disposal of the business interest, loss of U.S. citizenship by the qualified heir, or moving the business outside of the United States. The recapture tax is phased down gradually during the 7th through 10th years of the recapture period.

Qualifying assets must be used by the decedent for 5 out of 8 years prior to death and by the qualified heir for 10 years after death. However, the trade or business requirement can be met by renting, even cash renting, the assets to a family member or to a family-owned entity who uses the assets in an active trade or business. Care must be taken because the people defined as family members can be different before death and after death.

Ohio recently enacted an identical deduction for Ohio estate tax purposes by specific reference to the federal provisions. However, the federal repeal in 2004-2010 also may have effectively repealed this provision for Ohio in those years as well.

Disclaimer

A disclaimer is a powerful tool which allows heirs to do some limited estate planning after death. For example, a husband’s idea of estate planning might be to leave everything to his wife and let her worry about it. However, the wife is not legally obligated to accept the property. If the wife does not need or want the property, she may disclaim the property, in which case it passes according to the Ohio Statute of Descent and Distribution. An heir may disclaim all or part of an inheritance. Unless the husband’s will provides differently, whatever property the wife disclaims will go to her children equally. If she has no children, it will pass to others as spelled out in the statute.

The wife in our example cannot guide or redirect where the property goes. However, the husband’s will could contain a provision that says, if my wife disclaims this property I want it to go to X, Y, and Z. Including such a provision in the husband’s will gives his named heirs a chance to do some post-death estate planning. However, even if there is no provision in the will, to direct where the property goes upon disclaimer, one or more heirs may wisely choose to disclaim some or all the property left to them and let it pass to others under state law.

Extended Payment of Taxes

Time of paying federal and Ohio estate taxes may be extended. Normally estate taxes are due by nine months after death.

In order to avoid a forced sale of a closely-held business to pay estate taxes, both federal and Ohio estate tax rules allow estates to stretch out payment of estate taxes over a 15-year period. If funds are needed by the executor, no tax need be paid for the first 5 years. Interest must be paid, however. Only two percent interest is charged on up to the first \$1,120,000 in value of closely-held business in excess of the applicable exclusion amount for federal estate tax purposes in 2003. Again, the \$1,120,000 amount is indexed for inflation, increasing in units of \$10,000. This provision only applies to assets in a closely-held trade or business. Cash renting the farm to a tenant outside the family would not qualify. A share rental arrangement for operating the farm does qualify.

The Ohio estate tax payment extension provides that, if a significant portion of the estate is a farm or closely held business assets, then an executor may apply for an extension. There is an annual application for the extension for a period not to exceed 14 years.

Federal Special Estate Tax Valuation for Farms

Real property must be valued at fair market value at the time of death or at an alternate date 6 months after death. However, an executor can elect to value real estate used in farming (or in other closely held business), based upon its current value as a farm rather than its "highest and best" use for federal estate taxes.

To qualify for special use valuation, the real property must have been used as a farm, and the decedent or a member of the family must have materially participated in the farm operations for five of the last eight years before the decedent's death, retirement, or disability. The decedent or a member of his or her family must also have been at risk. This test cannot be met by a cash rent landlord renting to a non-family member. The value of the farm real estate must have been at least 25 percent of the gross estate, and the value of the real and personal property used in farming must have been at least 50 percent of the net estate. In addition, the decedent must have been a U.S. citizen or resident; the farm must pass to a spouse, children, or close relative; and the reduction in estate value cannot exceed \$820,000 for dates of death in 2002 and \$840,000 in 2003. This \$840,000 will be indexed for inflation, with increases in increments of \$10,000.

Special use value is based upon capitalizing for the most recent five-year period, average cash rents for similar property (less property taxes), using average annual interest rates for all new Federal Farm Credit Bank loans. For example, if similar farmland rents for \$60 per acre less \$5 property tax = \$55 net divided by 10% interest = \$550 per acre use value.

If within 10 years after the decedent's death the heir sells or transfers a portion or all of the farm to non-family members or it is used for other than farming, all of the estate tax savings on that portion are recaptured.

Installment Sale

An installment sale can achieve two important goals: (1) a reasonable degree of financial security for the parents and (2) a reasonable degree of opportunity for a child to purchase the family farm or business. In addition, the child operating the farm is provided with the maximum incentive to save money and maintain the productivity of the farm.

The payment schedule should be chosen with four factors in mind:

1. the purchase price of the farm,
2. the size of payments the child can expect to make out of the anticipated farm income,

3. the anticipated lifetime of the surviving parent, and
4. the needs of the parents.

The installment sale can be by a land contract or a deed and mortgage. The difference is in who holds the deed.

From a business viewpoint, the sale of the farm from parents to the farm-operating child on installments, either by a land contract or deed and mortgage, has much to commend it. It is a clean-cut business transaction, and all parties know where they stand. Children know they will get the farm if they do what they have agreed to do. The parents can use the interest and principal payments for their needs during retirement. They can also avoid any re-investment problem involved with an outright cash sale or with an accelerated payment schedule. If the child fails to make the payments, the parents can regain possession of the farm. The other children are not left out by such a sale. The balance due under the contract, as well as the unexpended money received from the sale of the farm, become part of the parents' estate and are distributed to the heirs.

Tax liability can be a major drawback to an installment sale, especially when the property has a low cost basis compared to the sale price. Each payment must be allocated between capital gain and interest, and taxes paid. Tax is due on capital gains realized. Any depreciation recapture resulting from the sale must be reported in the year of sale. This is more likely to be a serious problem where machinery is involved in the sale. Also, a minimum interest rate equal to the current Applicable Federal Rate (AFR) must be stated and paid on installment sales, or a higher rate will be imputed by the IRS, with basis and income tax implications. The applicable federal rates are published monthly and can be obtained from IRS. If the property is sold to a related buyer who subsequently disposes of the property within two years, all or part of the gain received by the related party will be treated as if received by the original seller. The balance due on an installment contract becomes part of the estate at the death of the seller.

An installment sale can provide cash for gifts to the purchaser or other family members. If gifts to any one person exceed the annual \$10,000 exclusion (or later increased amounts), a federal gift tax return will be required. However, no gift tax would be due unless donors had used all their unified credit. (See Table 8.) Gifts should not be in the form of a forgiven payment, but the payment should be received, then the gift made as a separate transaction. Income taxes still apply on the amount of payment due even if an equal amount is given away.

Under present income tax law, the tax on the gain can result in a significant reduction in net proceeds from the sale. Consequently, it may be difficult to achieve higher total dollar returns than those from keeping and leasing the farm. In some circumstances a long-term lease arrangement with the potential heir, with option to purchase, may be a viable alternative. Then the heir can get a new "stepped up" basis in the property through the estate, and the estate taxes may be small compared to the capital gains tax on a sale.

Life Insurance

Life insurance is often thought of as a means to protect a family against loss of income in the event of the premature death of the primary breadwinner. It also can have additional roles. It can provide cash in an estate to pay estate settlement costs, pay off debt, balance inheritance among heirs, or fund the buyout of a business.

The cost of life insurance varies by age, sex, and health of the insured, insurance company, and by the type of insurance, as shown in Table 1. The costs per \$1,000 also generally decrease as the face value increases.

Table 1. Range in Annual Premium on a 10-year Level Term Life Policy With a \$100,000 Face Value for Persons With No Apparent Health Problems*

	Single Female Age 25	Married Male Age 45
Non-Smoker	\$57 - \$231	\$118 - \$489
Smoker	\$92 - \$312	\$224 - \$911

*Taken from a November 2001 sample of 40 insurance companies selling insurance in Ohio by the Ohio Department of Insurance.

Term insurance is generally least expensive per dollar of face value because it provides only insurance, it is for only a specified period of time, and it builds no cash value. The figures shown are for a policy which is guaranteed renewable each year. The premiums for the next 10-year period would be higher due to increased age and would also vary by the health of the applicant. Term insurance works well for young persons with families when the need for insurance is great and income may be limited. Most term policies cannot be renewed beyond the age of 65 or 70.

In Table 1 notice that policies from the highest price company frequently cost 3 or 4 times as much as for the lowest cost insurance with exactly the same benefits. It clearly shows it pays to get quotes from different companies before buying life insurance of any kind.

One item missing from the table is the financial stability and integrity of the insurance companies. Some insurance companies are more financially sound than others. It is important that the insurance company is financially sound enough to still be in business when the insured dies and the beneficiary wants to cash it in. There are several rating services that rate insurance companies. For a list of rating services visit the Ohio Department of Insurance site at <http://www.ohioinsurance.gov/consumserv/ocs/ocspub.htm> then click on Shopper's Guide to Life Insurance and click on Picking a Company.

Premiums are usually substantially higher for ordinary life insurance (not shown) and are constant over the life of the insured. In the early years of the policy, the excess above the amount needed to pay off policies for those dying that year and current operating costs is invested by the company. This builds a reserve or cash value which increases over the life of the policy. There is also a substantial difference in the cost of ordinary life insurance.

Variable life insurance is a type which is popular now—it includes a higher degree of investment than ordinary life. The annual premium for a variable life policy would be higher than those shown but would vary widely between companies and types of policies. More detailed information about life insurance is available from the Ohio Department of Insurance at <http://www.ohioinsurance.gov/consumserv/ocs/ocspub.htm> then click on Shopper's Guide to Life Insurance and click on Whole Life Insurance.

There are four parties to a life insurance contract:

1. the insurance company,
2. the insured,
3. the owner, and
4. the beneficiary.

The selection of a financially sound insurance company is very important. One of the insurance rating services should be checked to obtain this information.

The owner, the insured, and the beneficiary(ies) may be vested all in one person, may involve two

persons, or may be three separate individuals. In Ohio, an insurance policy is not subject to estate tax unless the insured's estate is the beneficiary. For federal estate tax, the insurance policy is subject to taxation if the insured is the owner.

Ohio law does not usually present a concern because the estate is seldom made the beneficiary. The federal tax law does present a concern. It is not unusual for the insured to also be the owner. If a person's estate exceeds \$1,000,000 (or the amount at which taxed), the inclusion of life insurance increases the federal estate tax. The ownership on policies needs to be carefully checked.

How might a family use life insurance to reduce problems in settling an estate by providing liquidity? If by examining the husband's probable estate and estimated estate settlement costs, it is felt that \$50,000 cash might be needed, the wife might buy \$50,000 of life insurance on the husband's life, using her own funds or income, owning the policy herself and naming herself as beneficiary. At the husband's death the \$50,000 is then available to pay costs of the estate, although the wife is not obligated to use the funds for those purposes. This is an alternative to borrowing against the real estate or selling part of it to settle the estate. The husband can purchase insurance on the wife's life for the same purpose in her estate.

Life insurance is also useful upon the second death of a husband and wife. Often this is when the highest estate settlement costs are experienced. Some companies offer "survivorship" policies which pay at the death of the second spouse. Other uses of life insurance proceeds are:

- to provide funds for paying debt,
- for funding the living needs of a family,
- for one child to buy out siblings in case of the child wanting to continue the business,
- to provide a way to create more fairness among the beneficiaries, or
- to enable a buyout in case two or more owners have a closely held business and a death of one of the owners should occur.

Ohio Use Valuation of Farmland for Estate Taxes

Ohio has legislation patterned after the Federal Special Use Value, but much simpler. If the executor elects, the farmland will be valued under the same Current Agricultural Use Value procedure used for Ohio property taxes. To qualify, the property must be located in Ohio and pass to a member of the decedent's family. At least 50 percent of the net worth of the decedent's estate must be in farm real or personal property, and at least 25 percent of the net worth of the decedent's estate must be in farm real estate, both using fair market values, and the land must have been held in use for agricultural purposes. The agricultural purposes test is the same one used for current agricultural use valuation for real estate taxation.

There is a potential recapture of the tax saved, with interest, if the property ceases to be used for farming purposes or is sold to a person who is not a member of the decedent's family within four years after the decedent's death. However, cash rented real estate can still qualify for Ohio purposes. On the other hand, the Ohio election has a maximum reduction of value of \$500,000, which is not indexed for inflation. You may elect either Federal Special Use Value or Ohio Use Valuation, both or none in filing your return.

Right of First Refusal

The right of first refusal is an agreement made between a seller and a potential buyer allowing the buyer the option to purchase certain items in the future by matching any other bids. For example, if an outsider wants to buy all or part of the "family farm" from "mom and dad," the child(ren) with the right of first refusal has the option of matching the bid or walking away from the deal. The buyer pays for the right and usually has the right for some specified time, which may be decades.

Right of first refusal is common in the real estate market as a way of holding on to potential buyers. It is also common in divorce agreements that say before either parent can use the services of a baby-sitter or other third-party care giver, the other parent must be given the opportunity to care for the child during that time.

Here we are introducing a slightly different use of right of first refusal under which the child(ren) pays for the right to purchase certain property from a parent(s), IF the parent(s) decides to sell it. Unlike a purchase option, the child(ren) does not have the right to purchase at any time. The parent(s), as seller, would initiate the process, not the child(ren). The child(ren) should pay the parent(s), at least a nominal sum, for a right of first refusal. The payment of “consideration” strengthens the legality of the right of first refusal.

This type of right of first refusal would generally be used when the current owner(s) of property wants to retain current ownership of the property, but is willing to legally agree that if they sell it, they will first offer to sell it to the specified other persons. It is not common for a parent(s) and child(ren) to enter into such a legal right of first refusal, but at times it may make sense to do so.

Creating a legal right of first refusal does not mean that the parent(s) has to sell or that the child(ren) has to buy the property specified in the agreement. It simply means that if the parent(s) offers it for sale, the child(ren) with the right of first refusal will have the first opportunity to purchase it. The parent(s) cannot sell it to someone else without first offering to sell it under the same terms to the child(ren) with the right of first refusal. Such a right can represent important security to an on-farm child(ren). A right of first refusal is a legal document that should be drafted by an attorney.

Why Consider a Right of First Refusal?

One common situation that might lead parent(s) and a child(ren) to enter into such an agreement is where financial or tax situations make a sale between parent(s) and a certain child impractical currently, but the parent(s) wants to give additional assurance to that child that if they should sell the property they will sell it to them. Having the child(ren) purchase a right of first refusal from the parent(s) is one way of providing the child(ren) additional security that some day they will get it. A properly drafted right of first refusal, in addition to a long-term lease to the potential purchaser, will provide some additional security to a child(ren) who is using the property to make a living.

A right of first refusal provides different assurance than a will that states that a certain child(ren) will receive certain property at death. A person can change his or her will without the benefactors knowing about it. A right of first refusal is a legal document that limits the seller’s sales options.

It also may be useful to provide certain persons with purchase options in a will. Frequently the purchase provisions are favorable to the child(ren) purchasing the property. One problem with a child(ren) relying on a parent’s will is that wills are easily changed without the child(ren) knowing until after the parent’s death.

Possible Problems

One frustrating thing about the right of first refusal is that there is no assurance that the property will be offered for sale. It may never be offered for sale during the potential buyer’s lifetime. The right of first refusal simply provides that if the owner(s) wants to sell the property the person(s) with the right can buy it.

Sometimes a worse frustration occurs when the property is offered for sale, but the child(ren) who holds the right to buy is unable to buy it. The child(ren) may have become financially unable or may have simply reached an age when they no longer want to take the financial risk associated with purchasing it.

Sometimes conditions change so the parent(s) no longer wants to sell to the child(ren) holding the right to purchase. There may have been a disagreement or a change in circumstance such as a death, disability, or divorce that makes a sale less desirable. Sometimes the parent(s) can buy back the right. Other times they may simply refuse to sell. Or, if they have to sell, they may have to sell to a child(ren) other than the one to whom they would prefer to sell at the time of sale.

Valuation Concerns

A method for determining price may be in the agreement. The method could require:

- an appraisal,
- matching of another bid,
- valuation by formula,
- capitalization of earnings,
- annual agreement, or
- another reasonable method.

If the price is near fair market value when set, and the buyer pays reasonable consideration for the right of first refusal, it probably will be acceptable to the IRS. However, any attempt to set the price artificially low, freeze prices, or avoid estate or gift taxes is likely to come under the scrutiny of the IRS.

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