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ANALYSIS OF NONFARM EQUITY FORMS OF
INVESTMENT APPLICABLE TO AGRICULTURE

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U.S. agriculture has an "on again, off again" relationship with nonfarm equity capital. On the one hand, investor capital enables entry and expansion, while on the other hand it is characterized as threatening owner-operator control and encouraging large-scale farms to dominate production and marketing.

The mid-1980's find U.S. farmers in a mixed scramble to both scale down and to expand. However, debt capital is unusually tight as traditional lenders are balking at loan applications that would have been readily approved in the 1970's. The purpose of this article is to examine legal business forms and ownership mechanisms that would enable nonfarm investors to contribute towards the current capital needs of U.S. agriculture.

Farm Capital
One typically thinks of investment as a capital contribution to an already existing farm business, yet the large number of farm foreclosures and bankruptcy liquidations in the mid-1980's suggests that equity capital may be equally important as substitute equity--allowing farmers with untenable financial positions to exist, or moving large creditor inventories of repossessed collateral. But additional equity can be brought into agriculture, without "old equity" selling out entirely. Farming mentality traditionally responds to a "capital

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shortage" as answerable only by additional borrowing or selling of assets.

Equity capital can be made directly available to the farm operation by investors who want to participate in gains in exchange for risk sharing as well as by farm asset owners who make their income-producing assets available to farmers through leasing. In both cases, the farm operator would participate in, if not control, decision making.

The investment forms selected for discussion include financial leases and leasebacks, limited partnerships, and corporations. Other investment business forms or mechanisms include general partnerships, co-ownership, agency contracts, condominiums, trusts, and production contracts. Before describing these alternative investment forms, it may be useful to examine the reasons for using various legal entities.

REASONS FOR SELECTING A PARTICULAR BUSINESS ENTITY

Two or more persons can pool their capital in a common enterprise without utilizing a formal legal entity, yet their investment agreement would necessarily be lengthy in order to anticipate issues involving management, income tax treatment, liability for business debts and accidents, and withdrawal or death on an investor. By using a statutorily recognized legal entity such as the corporation or limited partnership, capital-pooling investors automatically have many of these concerns resolved as each entity is defined by statutes, regulations, and case law.

When selecting a legal entity to bring in outside equity investment, the following checklist points out major considerations:

- (1) Business continuity: When an investor retires, dies, becomes disabled, or simply wants to withdraw from the

farm investment, will this cause the farming operation to liquidate?

- (2) Income tax minimization: Is the legal entity subject to income taxes? If so, at what rates? How are distributions to investors taxed?
- (3) Management control: Do all investors participate in decision making equally, pro rata per capital investment, or are some investors given exclusive control?
- (4) Limits on business liability: Is an investor's liability limited to his investment, or is there no limit?
- (5) State restriction on certain legal entities from engaging in farming or owning farmland: Are there such statutes in the state of the farm operation? Are there exceptions applicable to some legal entities, type of investors, or farming activities?

LEGAL ENTITIES CONDUCIVE TO POOLING

NON-FARM EQUITY FOR AGRICULTURAL INVESTMENT

Limiting liability is assumed to be of utmost importance when a legal entity is to serve as an investment conduit for non-farm venture capital. This would eliminate the general partnership from consideration, as it has the characteristic of unlimited liability for all partners (jointly and severally). Leases, limited partnerships, and corporations are illustrative of investment vehicles in which liability, income tax treatment, and decision-making procedures are meticulously detailed by both contract and statute.

Financial Leases and Sale-Leasebacks

Leases represent the gray area between equity and debt capital.

Farmers facing difficulty in getting sufficient debt capital should consider the potential benefits of leasing. Analysts of agricultural leases for machinery, livestock, and specialized structures generally conclude that leasing is not a profitable alternative for the average farmer (LaDue et al.). However, there are situations where leasing is a viable option, such as when (a) the farmer is unable to borrow yet leasing would provide sufficient net return, (b) tax benefits such as depreciation and investment tax credit are of little benefit to the farmer, (c) borrowed funds have a higher-than-lease-breakeven cost, (d) cash flow can be improved, and/or (e) the purchase price of the asset to be leased is expected to drop during the lease period.

A major benefit from leasing arises from its income tax treatment. Federal income tax laws were substantially modified in 1981 and 1982, allowing leases a "safe harbor" to insure favorable tax treatment to the lessors if lease structuring guidelines were followed, particularly for leases of farm property up to \$150,000 per year. Even a fixed price purchase option will not upset lease tax treatment as long as it is at least ten percent of the original purchase price.

Financial leases can be structured with a farmer's existing assets via a "sale-leaseback" transaction, wherein the farmer passes title to a purchaser in a sale transaction and then leases the same property back. The sale-leaseback potentially can lessen the farmer's debt loan, provide cash flow, and provide tax shelter for the purchaser/lessor. Disadvantages to the farmer/lessee include possible income taxes (capital gains and recapture). At a time when lenders are restricting loan limits against existing farm collateral, the sale-leaseback

transaction would seem to provide a viable method for farm asset owners to borrow against their "equity."

Financially-troubled farmers will not usually find the investor waiting on their doorstep with a sale-leaseback proposal in hand. It will be up to farmers to seek out "lessors" and to market the benefits of leasing. Farm lessees must necessarily provide economic security for the leased property, projecting adequate cash flows to meet lease payment schedules but also providing proper management to maintain and to safeguard the leased property.

One final word of caution with sale-leasebacks: avoid "related-party" sale-leasebacks, such as between parents and children, as the Internal Revenue Service may well challenge the arrangement as a tax-avoidance scheme. Similarly, sale-leasebacks between a farmer/debtor and an existing lender are suspect transactions that might trigger a tax challenge.

Limited Partnerships

Every state has statutes authorizing the formation of limited partnerships, and no state prohibits limited partnerships from engaging in farming activities or owning/leasing farmland. In a limited partnership, there are two classes of partners: general and limited. The general partner(s) has exclusive management control but unlimited liability. The limited partnership offers two important legal characteristics to investors who are limited partners: limited liability and conduit income tax treatment. The disadvantages potentially facing limited partner investors include (1) lack of management control, (2) lack of a ready market for their "interests" should the wish to withdraw from the fund, (3) high management fees and

(4) uncertainty as to tax shelter benefits.

Since 1976, thirty states (including Missouri, Iowa, Kansas, Oklahoma, Nebraska, Wisconsin, Minnesota, Ohio, and North Dakota) have enacted a revised version of the Uniform Limited Partnership Act (ULPA). Limited partners' rights to participate in specified management decisions were given "safe harbor" protection from the former spectre that such actions might make them subject to unlimited liability as general partners. Limited partners in these states can avoid unlimited liability yet vote on (1) the removal of a general partner, (2) a change in the nature of the business, and (3) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business. Overall, the revised ULPA can be said to afford limited partners many of the same rights as stockholders have in a corporation.

Farm operators as general partners under the revised ULPA continue to have exclusive management control. No longer do limited partners have a priority over general partners for the return of capital contributions or the distributions of profits, unless the partnership agreement provides otherwise. Another change allowing greater flexibility in capitalization is that the capital contributions under the revised ULPA can include services to be rendered in the future. For general partners who are capital poor when the limited partnership is formed but who will contribute management services, this allows them to obtain a greater share of profits and/or a priority distribution upon business dissolution.

Corporations

Corporations like limited partnerships offer investors limited liability. Income tax treatment will depend upon whether the

corporation qualifies and elects subchapter S tax status. With subchapter S tax status, the corporation would essentially offer investors the same conduit income tax benefits available in a general or limited partnership. Under present law, there can be as many as thirty-five shareholders in a subchapter S corporation, which provides ample flexibility for most farm operations seeking investors.

It should be pointed out that most agricultural states restrict "farm corporations" that own farmland and/or engage in farming. However, these same "prohibitions" usually have ample exemptions for "family farm" and "authorized farm" corporations. For example, Missouri's corporate farm restrictions exempt "authorized farm corporations" defined as consisting of natural persons and having at least two-thirds of their total net income from farming operations.

The principal drawback for farm operators in using the corporation to attract investors is the reduction in management control. If more than fifty percent of the voting stock is investor-owned, control is in the hands of the investors. To circumvent loss of control, a second class of stock (preferred, non-voting) could be created for the investors, yet this would prohibit subchapter S (conduit) income tax treatment. Dividends from a regularly-taxed corporation give rise to "double taxation" as the corporation first pays income tax on corporate income and then shareholders must treat dividends as taxable income.

Sources of Outside Equity for Agriculture

There are three distance sources of investment capital for agriculture: (1) family members of existing farm operations; (2) local investors, and (3) non-local investors. The source of equity capital will not necessarily determine the legal entity chosen to pool the

investment, but certainly can have impact upon the type of agricultural enterprise, provisions for withdrawal from the entity, and the emphasis upon tax shelter potential.

Family Members

In most farming communities, there are numerous examples of related farm families pooling labor during peak activity periods such as planting and harvest. These related families also have opportunities for joint investment in machinery, livestock, and land, as well as sharing of hired labor. Yet some farmers are hesitant to enter into such joint operations, because of difficulty in decision making, uncertainty as to income tax treatment of depreciation, investment credit, etc., and the spectre of liability for another's acts, whether for debts incurred or for farm accidents.

Since the late 1960's, much focus has been directed towards farm estate planning, one concern being the "locking in" of off-farm heirs with the on-farm heirs having nearly complete management control. If the inherited, second-generation family farm were to expand, seldom did the off-farm heirs contribute additional capital.

Yet there are investment opportunities for off-farm family members to contribute more equity to the family farm without being "locked out" of decision making or excluded from income tax benefits and asset appreciation. It is as much a "fixed mentality" problem as to the available ways of channeling equity into a business as it is a reluctance to share control and tax benefits, or to allow a fair return on equity capital. Perhaps the biggest obstacle to bringing together family-member equity capital is their reluctance to discuss control issues, tax benefits, and liability concerns. Differing personalities

and long-standing family rivalries represent a formidable challenge to getting family members to pool equity capital.

Local Investors

Nonfamily investors from the local community are a significant prospect for equity capital. One typically thinks first of wealthy nonfarmers such as doctors, lawyers, and businessmen. Not to be overlooked are successful local farmers. The current farm debt crisis brings out this potential, as significant numbers of commercial farmers not only have low debt but many have no debt. These can be venture capitalists just as much as the local urban investors. Farmers who invest in other farmers' operations have a keen business eye and respect for solid farm management.

Local investors may be easier to convince as the merits of a farm investment given that they know first-hand of the farm operator's reputation for sound management. Such investors also have the psychic satisfaction of being able to observe their investment.

Important to the local investors is that the overhead necessary to bring together investment capital is much less as compared to the costs of selling far-flung public syndications. Avoided are costs of complying with securities regulations (prospectus preparation), broker selling fees, and sizeable outlays for legal and accounting services.

Non-local Investor Syndications

The overhead of selling "interests" in publicly offered farming syndicates is sizeable, typically running 15% to 20% of the investor's contribution (Matthews and Rhodes). Brokerage fees range from 8% to 12%. Add to that \$25,000 to \$50,000 for legal and accounting services just to prepare the necessary promotional and securities prospectus.

Don't overlook the management fee, often prepaid, of 5% to 15%, for overseeing the investment and providing timely income tax information along with financial status reports.

The motivation of distant investors to invest in agricultural is primarily for income tax shelter (Matthews and Rhodes, Carman and Hardesty). Other reasons might economic return on investment, investment without management responsibility, and limited liability for business debts and accidents.

The 1970's witnessed significant influx of non-farm equity capital in cattle feeding, mostly via public limited partnership. One research report estimated \$150 million to over \$400 million invested in cattle feeding in early 1974, representing as much as 20% of the fed cattle industry (Matthews and Rhodes).

Since the 1970's, ag syndications continue to play a major investment role in selected agricultural enterprises such as cattle feeding, center-pivot irrigated crop farms, vineyards, citrus, nuts, and poultry. However, federal income tax law changes have lessened the tax sheltering opportunities formerly available to publicly offered syndications. Leveraging with nonrecourse loans was substantially eliminated in the 1976 Tax Reform Act. Increased scrutiny by the Internal Revenue Service into questionable practices of tax shelters has relegated the public syndication to a diminished role in attracting investment to agriculture. Tax shelters are available today less through large public syndications and more through private "funds" which pool investors each willing to invest \$50,000-\$100,000 instead of \$5,000-\$10,000 as in the cattle feeding funds of the 1970's.

The principal obstacle for most farm operations in attracting non-local investment is the sizeable overhead necessary to locate and to entice investors. While economic rates of return of 8% to 12% might otherwise be attractive to investors, promotional overhead of even as low as 5% significantly diminishes the appeal of agricultural investments.

POLICIES TO ENCOURAGE NONFARM
INVESTMENT IN AGRICULTURE

Long-term strategies to allow unrestricted equity flow into agriculture will probably remove what some would perceive as protections for existing farm segments. Yet these "protections" may actually contribute towards the financial distress experienced today among U.S. farmers. Agricultural economists should participate in a careful re-examination of the following policy options to bring nonfarm equity into an ailing farm economy:

- (a) Tax incentives to facilitate financially stressed farmers in liquidating assets, such as eliminating capital gains, the alternative minimum tax, and recapture of depreciation, investment credit. Another possibility is to allow net operating losses and capital losses to be transferred with assets upon sale;
- (b) Removal of state restrictions on pooled investment funds and foreign investors seeking agricultural investments;
- (c) Creation of an asset-owing or debt-warehousing entity to provide an infusion of public and/or private equity (Ashmead; Harl);

- (d) Enactment of a model statute in all states to clearly define tenant and landlord rights, whether the lease is long- or short-term, whether the leased property is real estate or personal property;
- (e) Removal of income tax law restrictions on favorable income tax treatment of transactions between "related parties," provided there is an arms-length negotiation resulting in fair market valuation. This would encourage sale (and leaseback) to children, parents, uncles and aunts, and nephews and nieces;
- (f) Changing income tax laws to encourage loan write-downs without triggering "debt forgiveness income" to the solvent debtor. Under present law, solvent debtors under seller-financing (installment land contracts) can avoid income recognition as long as the debt write-down is negotiated between the original debtor and seller, is arm's length, and is not written down below fair market value. Extend the same tax treatment to all debt write-down, whether the lender is the original seller or not.

Changing laws, especially income tax laws, to encourage primarily high tax-bracket investors to buy assets of financially floundering farmers is a volatile political issue. On the positive side, these changes point towards stabilizing farm asset values. On the negative side, tax-oriented investment in agriculture, especially by nonfarm investors, still has many skeptics. Some would argue U.S. agriculture must further adjust asset values downwardly before long-term

profitability can be achieved (Lins and Klinefelter). Existing financially successful farmers can be expected to argue against the "unfairness" of changing the game rules for the "losers".

CONCLUDING COMMENTS

Nonfarm equity infusion into U.S. agriculture raises long-standing concerns about tax shelter investors, separation of ownership and management control, and trends toward large farms. Ironically, the hard financial times in agriculture of the 1980's have caused lenders to restrict credit and to employ credit management procedures, both greatly influencing farmer behavior, perhaps more than would equity investors via limited partnerships, leases, or corporations. For struggling farmers today, farm ownership as a goal may necessarily have to take second seat to the more immediate goal of business survival. When goals such as profit stability and maximizing net worth are placed at the forefront as farm business objectives, diversification becomes an important concern. Farm businesses may increasingly diversify into nonfarm investment rather than constant reinvestment into their own farm businesses. With such economic objectives, farmers are likely to be more willing to share ownership rewards in return for risk sharing. The equity infusion need not mean a significant loss of control and may well be less costly than use of debt capital.

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