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AGRICULTURE AND LIMITED PARTNERSHIPS:
THEIR COMPATIBILITY

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Investment in agriculture during the 1970s has taken a myriad of forms though one investment vehicle has dominated the imagination of non-farm investors: the limited partnership, better known as a "fund". The purpose of this paper is to examine the basic characteristics of this legal entity, both in the abstract and as applied.

A limited partnership is a partnership having as members one or more general partners and one or more limited partners. As a business organizational form, the limited partnership is wholly a creature of statutory provision, unlike the general partnership with its common law foundation. Once seemingly restricted to Broadway productions and oil and gas exploration, limited partnerships spread into agriculture within a relatively recent period. In cattle feeding the pioneers in public fund offerings date back no farther than the late 1960s, yet by 1973 funds had become so widespread in cattle feeding that estimates place as much as \$350-400 million of tax-induced equity capital in this industry, channeled primarily through the cattle feeding funds [I, pg. 10]. The egg industry now has two large funds, the earlier formed only in late 1972.

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Limited partnerships are also present in the commodity areas of grape/wine production, citrus, and pistachio nuts.

As an illustration of the tax shelter glamour of the cattle feeding funds, consider an investor in the 50% tax bracket contributing \$10,000, to be mingled with similar amounts from one hundred other well-heeled investors. Figure 1 shows the tax deferral benefits potentially available to the individual investor in a fund. As shown in the figure, the investor has achieved a first-year tax savings of \$7,500. By continuing to reinvest the proceeds from each cattle sale, the investor will be postponing tax liability on his original equity contribution until the fund is terminated. By terminating his investment in a year when his tax bracket is lower, the investor will be able to actually reduce his tax liability, in addition to the tax deferral. This example assumes the investor broke even on his investment. Should the venture yield profits, so much the better.

Basic Characteristics of the Limited Partnership

Because the general partners have exclusive management control [2, Section 17], their number is restricted to smaller numbers on a practical basis. Otherwise, management would be too burdened with disputes and control struggles. The general partner class is often a single corporation, especially in the agricultural limited partnerships.

The limited partners may be individuals or any other

Figure 1. First-Year Tax Benefits For a Fund Investor

<u>Source of Funds</u>		<u>Use of Funds</u>	
Investor's Cash	\$10,000	Purchase 100 steers @\$250/head	\$25,000
Bank Borrowings (\$5,000 nonre- course)	<u>30,000</u>	Feed, medicine, management ser- vices	<u>15,000</u>
Total	\$40,000	Total	\$40,000

First-Year Tax Situation

Reportable tax loss	\$15,000
Tax Saving for Investor in 50% tax-bracket	\$ 7,500

types of "person" that the state statutes together with judicial interpretation will allow. It is not uncommon to find trusts, estates, and corporations as limited partners. However, the majority of limited partners are generally individuals. The stereotype limited partner is a doctor, lawyer, movie star, or sports superstar. To the degree that any members of these groups possess large annual incomes and incur the prospect of a huge tax "bite", this generalization might be described as fairly accurate. The size of the limited partner class varies, determined largely by the amounts of individual contributions and the requirements for the proposed business. A common count for this class in the cattle feeding limited partnerships will be between 50 and 200 investors, yet numbers much larger, as well as smaller, are not infrequent. In actual practice in the agricultural ventures the general partner class is often made up of a single corporation which makes a nominal capital contribution, if any. Hence, the limited partners supply substantially all the risk capital for the business venture. ✓

Liability

The general partners are subject to the liabilities of partners in a general partnership, i.e., unlimited liability. The limited partners have their liability restricted to the amount of their contributions as stated in the certificate plus any undistributed profits. This characteristic of limited liability has made the limited partnership attractive to investors in many speculative ventures as oil exploration, realty

developments, and cattle feeding.

Management Control

By statute, all the management control powers of a limited partnership are vested in the class of general partners. Should a limited partner be deemed to have exercised "control", the liability of a general partner will be thrust upon him. The restraining hand on general partners was conceptually to be subjection to unlimited liability [3, pg. 717]. Realistically, a corporate general partner is all too often a thinly capitalized shell. The interposition of a corporation as a general partner would apparently shield its shareholders from the unlimited liability cast upon the general partner corporation.

Costs of Organization

The organizers of a limited partnership fund will incur a great deal of legal, accounting, and printing expense in setting up the partnership agreement and in drafting and registering a prospectus statement with state and federal securities agencies. For a public offering these costs will range generally from \$50,000 to \$200,000 [4, pg. 234]. The fund promoter, usually the proposed general partner, is liable for these organizational costs. Accordingly, the general partner's profit share, management fee, or other source of remuneration will generally assume the character of a repayment for the organizational costs. Alternatively, some funds are structured so

that upon formation a fixed amount or percentage of contributions will be applied to the payment of such expenses, thereby relieving the promoter of liability.

Securities Regulation

It is well-settled that the sale of interests in limited partnerships is to be treated as the sale of "securities" [5]. The sale of securities is regulated by both the federal and state securities laws. The federal laws are enforced by the Securities Exchange Commission (SEC). The SEC requires that full disclosure of all relevant investment information be made, embodied chiefly in the form of a prospectus statement. A prospectus is an informational booklet required to be delivered to potential investors with solicitation efforts during the registration period. State regulation of securities is provided for in "blue sky" statutes, so named because early abuse in securities deals featured land tracts in the blue sky in fee simple. Blue sky laws also generally require the filing of relevant investment material with the state securities commissioner and the delivery of a prospectus to potential investors. Registration with state securities agencies must be accomplished in addition to the filing procedure with the federal agency (SEC). These filing procedures are costly and time-consuming and present a major planning obstacle to the fund organizers.

Federal Income Taxation

A limited partnership may be taxed either as an "association" or as a "partnership". The determination is based principally upon the absence or presence of various associational characteristics, set out in the Treasury regulations [6]. The reason for the effort to avoid taxation as an association hinges upon the advantages to the investing partners when partnership tax status is available. Partnership tax status enables the limited partnership to serve as a conduit to the individual partners for the various business deductions and operating losses from the fund activities via the combination of cash accounting and deductible expenses. Fund losses are available to the limited partners for direct application against non-fund income, yielding a reduction in current tax liability. On the other hand, "associational" tax status would result in the deductions and operating losses being accounted for at the business entity level, not at the individual investor's level. The quintessence of modern-day limited partnerships is the achievement of tax deferral and/or capital gains conversion of income. Without partnership tax status, tax shelter of a limited partnership is largely defunct. ✓

Advantages/Disadvantages to Fund Participants

The General Partner(s)

The major advantages in a limited partnership for the class of general partners are the following:

- 1) unrestricted management control of the business;
- 2) the availability of capital from the limited partner investors;
- 3) the opportunity to apportion the overhead of an existing organization (the general partner's corporate group) to the limited partnership;
- 4) the fuller use of organizational capacity, whether it be management or land holdings and facilities;
- 5) less dilution or infringement of control compared to that exercised and required by large lenders (banks and other financial institutions); and
- 6) the development of expertise in the marketing of securities.

The availability of large equity capital amounts without management restrictions makes a most enticing package for any management group.

Although the advantages seem numerous, disadvantages to the general partners are present. The spectre of unlimited liability for partnership debts and activities could loom large as a disadvantage. The use of a corporation as a single general partner diminishes this threat, as previously discussed. Another disadvantage is the time and expense required to draft, to register, and to promote the public offering of limited partnership interests. If these are not enough impediments to slow down the scramble to become general partners, perhaps the thought of playing nursemaid to the numerous queries and visits of the limited partners will present a formidable challenge. These efforts must go beyond the preparation of the annual president's report to include quarterly, if not monthly,

reports on the fund's activities, as well as timely tax information for use in the preparation of the limited partners' individual tax returns. A more intangible yet nevertheless real area of concern for the general partners is the possibility that tax reform legislation will remove much of the shelter incentives for limited partnerships. Hence, the need for counteraction via lobbyists. The general partners may enjoy several advantages, yet their "way of life" is not without its drawbacks.

The Limited Partners

The limited partnership poses the following potential advantages for limited partners:

- 1) tax shelter;
- 2) economic return on their investment;
- 3) investment without management responsibility;
- 4) limited liability; and
- 5) schmaltz.

"Schmaltz" refers to the real or imagined desire of investors to capture the newness of an innovation or approach before other investors overcrowd the industry or legislative response lowers the boom on another lucrative loophole. The excitement allowed the well-heeled investor by participating in an oil exploration venture or owning together with club members a lot of cattle is difficult if not impossible to measure quantitatively in assessing investor rationale for buying limited partnership interests. To discount this attraction of a

limited partnership is most unrealistic, as promoters are apt to admit.

The disadvantages facing the limited partners are quite real, too, and include the following:

- 1) high management fees to the general partner;
- 2) no control over management decisions;
- 3) lack of a ready market for their interests;
- 4) difficulty in guarding against and/or remedying unfair management practices as self-dealing;
- 5) the spectre that unlimited liability might be imposed; and
- 6) the collapsibility of promised shelter.

An additional drawback for the limited partners is the likelihood of economic losses, whether caused by high input prices, low product prices, poor management practices, or some combination. The limited partner indeed subjects himself to more than the nebulous prospect of tax shelter.

Viability of a Firm as a Limited Partnership

Before a limited partnership fund can be viable for a firm, in agriculture or elsewhere, certain basic characteristics are conducive to successful implementation. First, the adopting firm must have those types of business expenses capable of serving as a basis for tax shelter, i.e., deductible expenses. In the agricultural funds, deductible expenses include feed, fertilizer, interest, management fees, medicine and veterinary services, crop and tree planting expenses, irrigation rights,

and depreciation. Second, the firm must have need for sizable amounts of capital. Otherwise, promotion cost of upwards of \$50,000 would cripple funds capitalized at low levels. Third, a firm adopting the fund approach must be blessed with what is labeled sophisticated management.

Sophisticated management refers to that type of management ability capable of utilizing the skills necessary in organizing and successfully promoting and operating a legal entity as the limited partnership. If the management does not itself have accounting and legal ability, it must know where and how to obtain it. Management must be willing and able to cope with the complexities of large-scale financing activities. Such activities include the conceptualization process characteristic of large corporate organizations, the preparation and qualification of the relevant security filings with the SEC and the state blue sky commissioners, the provision for a network of broker-dealers and underwriters, and the continuing ability to smooth the many irregularities and to maintain harmony among so many diverse investors. Unless the fund is successfully launched, promotional costs involved in registration and organization will be borne solely by the promoter group -- a substantial risk for a management group to undertake when it has little or no familiarity with public offerings.

Perhaps not even all existing agricultural funds have "sophisticated management". Obviously, a firm familiar with large-scale financing and/or the corporate form of business organization would be more likely to possess such managerial

talent. Indeed, existing agricultural limited partnerships frequently have corporate general partners as the sole manager of the fund. These corporate general partners are themselves often subsidiary offshoots of larger, more complicated corporate organizations. However, the corporate general partner need not be large by non-agricultural firm standards in order to possess the drive characteristic of sophisticated management. Smaller corporate agricultural firms seeking the command of additional risk capital for their own purposes have commonly been the driving force in the numerous cattle feeding funds offered in the 1970s.

Factors Adversely Affecting Limited Partnerships

Negligible profits or substantial losses could seriously hamper the saleability of the schmaltzy funds. The losses prevalent in the fed cattle business in late 1973 and early 1974 have certainly not increased the marketability of feeding fund interests. The Internal Revenue Service also adversely affects the staying power of funds by its challenges to the deductability of prepaid feed expenses. Without the ability to deduct prepaid feed, the feeding fund is largely defunct in providing long-term tax shelter benefits. Congress is having its own effect upon the funds as it debates the desirability of substantive tax reform. The Administration in April, 1973 submitted its Proposals for Tax Reform which included a Limitation on Artificial Accounting Losses (LAL). LAL is intended to have a curbing effect on the limited partnership

tax shelters.

Although all the above factors contribute to the uncertainty surrounding the limited partnership, the fund has proved to be a most versatile investment vehicle. Absent unprofitable times or substantive tax reform, the viability of the limited partnership in agriculture would seem promising.

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