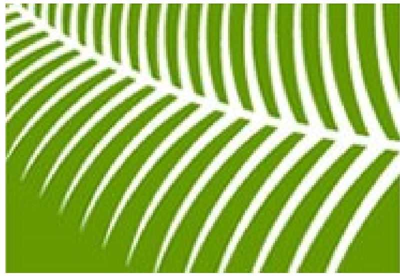

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CALCULATING THE DISCOUNT FOR INTRA FAMILY SALE OF ASSETS

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Abstract

Intra-family family farm business succession often requires the faming heir to purchase long term assets, land and facilities, from the non-faming heirs. The mechanisms for such purchases include option to buy, right of first refusal and buy/sell agreements. The control of these mechanisms is either in the hands of the buyer or the seller. The common factor is establishing the price to be used in the sale and purchase. Many farm family business succession plans require that asset(s) to be discounted from the fair market value. The discount recognizes the contribution of the farming heir to the preservation and addition to the estate of the owner. The owner generation must strike a balance between the farming and non-farming heirs' bequests and the ability of the farm business to fund the farming heir's purchase of the long term assets. A common approach is to discount the sale price to enable the farming heir to purchase the long term assets. Herein lies the problem: By what amount should the sale price be discounted? A second, but equally difficult problem, is how to insure the farming heir does not receive a windfall profit from an immediate sale of the long term assets after purchasing them at a discounted price. A useful approach is to determine the amount of debt service that the farm business can absorb. The second problem can be resolved by requiring a shared appreciation agreement for the purchase of the long term assets at a discounted price.

Key words: Succession, Discount, Appreciation, Buy/Sell, Intra-family, Estate, Planning

Farm family business are asset rich and cash poor. Simply put, if the farm business owner had to purchase all the assets necessary to operate the farm family business it, the farm family business, could not generate sufficient income to cover the cost of the purchase. Farmland, until recently, has appreciated at unprecedented rates thereby increasing the value of the farm business owner even in the face of declining profit margins. Unfortunately many farm business succession and estate plans require the faming heir to purchase the long term assets of the non-farm business heirs. Many farm business owner focus on the family ideal of "fairness" with little consideration of the ability of the business's ability to generate sufficient income to fund the purchase price and, at the same time, cover operating expenses for the business and living expenses for the farming heir.

A majority of farm business succession plans have provisions for the farming heir to purchase the short and intermediate term assets. These plans may include installment sale of machinery and livestock, equity in short and intermediate assets as a part of a compensation plan, gifts, or purchase of replacement equipment or livestock with the salvage or cull value paid to the farm business owner. Many farm businesses use the transfer of ownership interests in business entities as a method of transferring lumpy short and intermediate assets to the on farm heir or successor.

Long term assets such as land and facilities are usually transferred through to the heirs via an estate plan. The usual legal instruments to effectuate such transfers are will and trusts. A detailed description of the instruments is beyond the scope of this paper. However, whether by will or by trust the farming heir, the farm family business successor, is often required to purchase the long term assets from the non-farm business heirs. The mechanisms for such purchases include option to buy, right of first refusal and buy/sell

agreements. With each of these mechanisms there are issues of who triggers the transaction and are the terms of the transaction.

In an option to buy the seller, the non-farm heir, controls the event. The determination of when to sell is determined by the non-farm heirs. The price and terms of the sale may be governed by the estate plan. A right of first refusal is also controlled by the seller. The buyer has the right to purchase, usually at fair market value. In some cases the estate plan may govern the price and terms of sale. Neither the option to buy nor the right of first refusal require the seller to consider the ability of the farm business to meet the debt service amount that the sale would generate. And neither require the seller to consider the timing of the sale. A variety of factors can affect the ability of the farm business's ability to generate sufficient income to service the debt. These factors include, among others, crop failures due to weather or disease, market failure, current debt of the business and the larger economy.

The buyer, the seller or the estate plan can control the buy/sell event. The most common buy/sell agreements are cross purchase agreements, entity purchase agreements and wait and see agreements. A cross purchase agreement requires an asset owner to either buy or sell when another asset owner offers to buy or sell. If the business is operating as a business entity the entity purchase agreement requires the entity to buy the asset when it offered for sale. A wait and see agreement allows each asset owner, or in some cases the entity, to buy and if the requires either an asset owner or entity to buy. Buy/sell agreements may be funded with a combination of life insurance, personal savings, and retained earnings by the entity and business net income.

The control of the timing of the buy/sell agreement either in the hands of the buyer or the seller. And the control of the timing can be problematic for the same reasons as with the right of first refusal or the option to buy. If, however, the control is with the buyer, usually he farming heir, the buyer may never offer to buy. This create the situation where the non-farm heir(s) have ownership of an asset for which there is no ability to sell. Clearly, there must be controlling language in the buy/sell agreement to govern either situation.

A buy/sell agreement should specify a time limit for either the purchase or sale. It should specify whether the sale or purchase is by a contract for deed or by note and mortgage and set forth the remedy in the case of a default. If a contract for deed is required the buy/sell agreement should set forth the price, the length of the contract, the interest rate and the amortization schedule.

The common factor in each of the above listed mechanisms is the determination of the price of the asset. Many farm family business succession plans require that asset(s) to be discounted from the fair market value. This, of course, raises the question of how much should the value of the asset be discounted. The reason that discounts in values are employed is that such discounts recognizes the contribution of the farming heir to the preservation and addition to the wealth and value estate of the owner. Discounted values also compensate the farm business heir for intangible value such as relationships with suppliers, buyers, landlords, lenders and other "blue sky" values. If he farm family business has a direct market or wholesale enterprise the "blue sky" may be the most significant contributing factor to the overall value of the business and the estate.

The farm family business owner(s) want the farm family business to transition to the next generation they, the owner(s), must strike a balance between the farming and non-farming heirs' bequests and the ability of the farm business to fund the farming heir's purchase of the long term assets. Such a balance recognizes that an equal division of farm business assets is not a fair division of the farm business assets. When he farm family business succession plan requires the faming heir to purchase farm business assets from the non-farm heir a common approach is to discount the sale price to enable the farming heir to purchase the long term assets. Herein lies the problem: By what amount should the sale price be discounted?

As set forth above the estate plan can specify an interest rate, length of contact and amortization rate. Interest rate effect the amount of the payment, but not to the same degree as does the price of the asset to be sold. Length of contract is also a determinate of the payments and must be fair to the non-farm heirs. And the amortization schedule affects the amount of the payment. Price, however, has the greatest impact.

Given that many farm family business succession plans employ a discount in the price of the business assets, how should the amount of the discount be determined to insure the successful transition to the next

generation? A useful approach is to determine the amount of debt service that the farm business can absorb. Five variable must be considered. These are, net income available for debt service, price, interest rate, length of contact and amortization schedule.

Family expenses must be subtracted from the net income to determine the amount of income available for all debts. In determining this amount a trend line analysis should be performed. What is the trend over the last ten years of operation and what is the average amount available for debt service? The remaining factors are price, interest rate, length of contract and amortization schedule. Each of these variable can be adjusted.

The maximum amount of the debt must be equal ability of the farm business to generate sufficient income to fund a payment determined by price, interest rate, length of contract and amortization schedule. The impact of each of the variables is not the same. Length of contract and amortization schedule have a relatively greater impact that acceptable interest rates. Price is the greatest determinate. If one assumes an interest rate a percent below commercially available loans, a 20 year contract, and a twenty year amortization schedule then price must be discounted to a level where the net income available for debt service can make the payment.

A simple spread sheet is available from the Beginning Farmer Center at Iowa State University to calculate the discounted price.

The farm business owners and the non-farm heirs may be concerned that the farming heir could purchase the farm asset at the discounted price and the immediately sell it at fair market value. A shared appreciation agreement can allay such concerns by requiring he farming heir to share the windfall from the sale of the asset should the sale occur during a specified period of time.