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A PRIMER ON BUY-SELL ARRANGEMENTS FOR FARM PARTNERSHIPS

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Foreward

Many of the difficulties associated with discussing partnerships stem from ignorance that there are often three levels of ownership associated with a partnership. First, individual partners may own property that they lease to the partnership. Second, the partnership owns property referred to as "tenancy in partnership." Third, each partner owns a partnership interest. Each of the three types of property has a market value and each has its separate tax basis. It is possible for a partnership to sell property, a partner to sell his or her partnership interest, and a partner to sell property he or she had leased to the partnership. Adequate records are necessary to compute the taxable income upon the sale or transfer of any property interest.

Introduction

A farm partnership is a common way for a beginning farmer to start farming with an established farmer. Many are parent-child partnerships. As a multi-owner, multi-manager business, the partnership is generally easier to form, operate and dissolve than a corporation. Although either a partnership or corporation can be formed tax free, a partnership can often be dissolved tax free, which is usually more difficult with a corporation. In a parent-child business, where after exit of the parent the farm will again become a sole proprietorship, tax-free dissolution is an important characteristic.

Before a farm partnership begins the parties involved should agree upon how the partnership will be formed, how it will be operated, and how it will be dissolved. Agreement as to the formation of the partnership is always reached because it is imminent in order to establish the partnership. Operation is also often agreed upon, although many times it is unclear how the partnership will operate after a few years, when conditions have changed. All to often, however, the dissolution of the partnership is never even discussed.

The failure to arrive at agreeable provisions for the partnership dissolution can lead to frustration, dissappointment, and strained relationships when it becomes necessary to dissolve the partnership. And dissolution will someday occur, whether by death, disability, retirement, or by wish of one or more partners.

The purpose of this publication is to discuss the process of preparing a buy-sell arrangement for the partnership. When done correctly the dissolution is entirely planned before the partnership ever begins, so that when an incident that triggers dissolution occurs, such as a death, the dissolution process will be almost mechanical. Although the mechanics are different, much of what follows is also appropriate for closely held family farm corporations.

At the time that the partnership is formed you will not know with certainty if you or your successors will be a seller or potential buyer in a dissolution so you protect your interests and preferences under either possibility, as your fellow partners should. If you cannot come to an agreement before the partnership begins, the partnership should not be formed. That is generally a better outcome than having major disagreements at dissolution.

A change in ownership involves a number of decisions which should be based upon pertinent factors. One is the reason for the change in ownership. It may be because of death of a partner, retirement, or other reasons. The reason for the exit is important because it may control the procedure used to transfer ownership, how that transfer is financed, as well as valuing the interest. Another item is whether the partnership interest is sold or the partnership is dissolved. A discussion of these factors and decisions follows.

Reason for Exit

There are three primary reasons for exiting from a partnership--death, retirement, and a desire to leave. Some partnerships might be interested in other events which should activate a change in ownership, such as a divorce.

The reason for exit is important because it may influence the type of transfer, valuing the transfer, and financing the transfer. It is recommended that separate provisions be written for each type of exit.

At retirement a partner may be willing to receive payments for his or her interest over a number of years. At death it might be more desireable to settle payment rather promptly. If the desire is to get out of the partnership simply because of a change in aspirations, it might be appropriate to value that interest at a more conservative value.

Valuing the Partnership Interest

There are a number of procedures which may be utilized to value a partnership interest. Some are:

1) Fixed price
2) Appraised value
3) Capitalized value
4) Formula price
5) Offer price
6) Tax basis

Fixed Price

The simplest procedure is to fix a price in the agreement that will be used in any buy-sell transaction that may be necessary. The price fixed is often the value of the partnership, allocated among the partners, at the time the partnership was formed. The problem with a fixed price is that it is fixed. The value of the partnership may increase or decrease over time, making the fixed price unfair to a buyer or seller. To correct this many partnerships will change the fixed price annually, reflecting any change in value of the partnership. This procedure, however, has not always worked satisfactory because sometimes after a few years it becomes apparent who will become a buyer or seller (because of an illness for instance), and annual agreement becomes difficult to reach. Other partnerships simply become derelict in their annual updating.

Appraised Value

An exiting partner's interest can be appraised at the time of the exit, typically by a third party. The third party should be agreeable to both buyer and seller. If a third party appraiser can not be agreed upon or more than one appraisal is desired, both buyer and seller can each select an appraiser, and these two appraisers might pick a third appraiser so a consensus value can be reached. Some partnerships attempt the appraised process without the use of an professional appraiser. This is not always successful, but if agreement is not reached, they can then always resort to a third party appraiser. One major advantage from using an appraised value is that since it is a reflection of market value, the IRS is less likely to question whether a gift is occurring between seller and buyer (or vice versa). In constrast, using a low fixed price for a buy-sell activated at retirement obviously entails a gift from older to younger partners.

Capitalized Value

The value of business property is based upon the amount of income the property is expected to generate in the future. Although future income is not known, it is possible to estimate it using past and current income, and then discount these projections into a capitalized value. The simplest capitalization procedure is to take the current year's partnership income and divide by the cost of borrowing funds. For instance, if the current partnership income is \$30,000 and the cost of funds is 10 percent, the capitalized value of the partnership is \$300,000. Since farm partnership income can be erratic from year to year, it is often suggested that the average income and cost of funds for the last 5 years be used rather than income from just one year.

Capitalization values using historical incomes agree closely with market values when there has been little or no inflation. With inflation, capitalization values based upon historical incomes are lower than market values. The reason for the disagreement is simple--market values are a reflection of expected future income, capitalization values are based upon current and past income, which may be lower than future income under inflation.

Formula Price

The formula price is very similar to the capitalized value except that some measure other than income is used in a mathematical formula. The value of a dairy partnership, for instance, can be some multiple of the number of cows and the price of milk. Unless based upon sound economic principles a formula is not typically suggested, since the formula may cease to be relevant after a number of years.

Offer Price

This is a unique technique where the seller offers his or her partnership interest at a price that he or she has determined. The potential buyer has only two options--to buy the partnership interest at the offer price or to request the potential seller to buy rather than sell at that offer price (assuming equal ownership). The potential seller would then own the whole business (if two original partners) and could either operate the business as a sole proprietor or sell the business to a third party. The principle behind this technique is that the potential seller must offer his or her interest at a reasonable value or else end up buying the business at an unreasonable value. One problem with this technique is that a partner may not be in a position to finance an additional business purchase and a potential seller can use that information to set a low price to purchase the business. Adequate financing arrangements must be provided for.

Tax Basis

The tax basis of a partner's interest is what a partner has invested for tax purposes in the partnership. Because of appreciation and other factors the market value of a partner's interest is generally greater than his or her tax basis in the partnership interest. In most cases the tax basis will be much lower than the market value and obviously does not reflect the true value of the partnership interest. Using the tax basis as the sale value has one advantage. By selling at the tax basis the seller has no taxable gain.

Other

Other valuation techniques can and have been used in valuing a farm partnership interest. One technique that can be used in a liquidation is to pay the exiting partner an income for a stated period of time. That income may be based upon the profits of the partnership. One procedure is to pay the exiting partner the same income he would have made each year as a continuing partner but to only make the payments for 5, 10, or 15 years. Or, reduced payments may be made for life.

Estate Value

It is normally suggested that the remaining partners have an option to buy a deceased partner's interest rather than an obligation. However, it is generally recommended that the estate have the obligation to sell if the living partner exercise their option. If the estate is obligated to sell then the sale value established in the buy-sell arrangement would be the value used in the estate tax return. The heirs would pay no income tax on the sale except for the share of unrealized receivables (income in respect of the decedent) and there would be a tax credit if any estate tax had been paid on that income in respect of the decedent.

Financing the Partnership Transfer

There are three ways to finance the transfer of a partner's interest. One is for the selling partner to finance the sale by taking the proceeds in installments, the second is for a third party lender to finance the transfer, and the third is by the use of life insurance, which is only relevant for a death. A combination of these methods is often used. It is extremely important that financing arrangements be spelled out very clearly in a buy-sell arrangement. If the seller is to accept installment payments, then that must be stipulated in the partnership agreement. Otherwise the exiting partner may want the funds immediately, requiring a third party loan, which may not be available, with the result of the whole business being sold.

Seller Financing

A partnership interest can be sold on an installment basis like any other piece of property. A partnership interest qualifies for capital gain treatment so it is necessary to charge the buyer at least the minimum required interest rate. Payments may be stretched out for 10, 15, or even 20 or more years. A retiring selling partner may be especially pleased with an installment sale because it provides income with interest earnings during the retirement years. The installment sale also spreads out the taxable capital gain over a number of years, thus reducing income taxes.

A non-retiring exiting partner may prefer the funds to be paid in a lump sum in order to purchase another business or property. Heirs may also wish to receive their funds as soon as possible. An installment sale may, however, be forced upon these individuals if done so in the partnership agreement. If possible, it might be beneficial to pay a larger down payment in these cases to provide more initial funds for the sake of harmony.

Third Party Financing

Requiring third party financing must always be looked at skeptically. All partners at formation of the partnership may have the financial strength to obtain third party financing, but they may not always be in that favorable position. Plus, most sellers would prefer to spread the sale proceeds over a number of years anyway to reduce taxes.

Life Insurance

The use of life insurance is applicable for a buy-sell activated at the death of a partner. To use life insurance each partner or the partnership would purchase a life insurance policy on the life of each partner. When a partner dies the life insurance proceeds would be used to finance the transfer of all or part of the partnership interest. Since the deceased did not own the policy, the proceeds would not be included in his or her taxable estate; nor would the proceeds be subject to income tax. The premium payments would also be non-deductible.

It is not necessary that policies be purchased on all partners. Obviously older partners are more probable to die but then those policies cost more. In a parent-child partnership the cost difference between the parent's policy on the life of the child and the child's policy on the life of the parent can be drastic. Thus, it is often suggested that the partnership owns the policies and pays the premiums if both are to be insured. Partnership ownership is also suggested when more than two partners are involved because of the large number of policies that would be required if each of three or more partners buys a policy on two or more other partners. Partnership ownership of the policies necessitates an entity purchase (buy-out) rather than a cross purchase of the deceased partner's interest.

Whole life or term insurance may be used. However, buy life insurance as you would purchase any other major farm input -- shop around for quality and price. In some instances life insurance funding is only necessary when the partnership is young and fragile. Term insurance for 5 or 10 years may be appropriate with a shift to seller financing.

Conclusion

The preceeding was a brief discussion of relevant factors that are important in writing a farm partnership buy-sell arrangement. It is important that these be discussed thoroughly by all potential parties--partners and spouses. After agreement is reached it is important that an attorney write the partnership agreement. An attorney, an accountant, and other professionals should also advise you in more detail concerning the particulars and options of dissolving partnerships.