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Farm Partnerships-Part II: Legal Considerations

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Property Rights of a Partner

One of the established principles concerning partnerships is that both real and personal property may be owned in the partnership name. In Missouri, property owned by the partnership is held by "tenancy in partnership." Under such arrangements each partner is a co-owner of specific partnership property and has equal rights to possess and use the property for partnership purposes but no right to possess or use it for other purposes without the consent of his partners.

A partner cannot assign or sell his right in specific partnership property so as to give his assignee rights as a partner. Nor can claims against a partner attach to his right in specific partnership property.

Since existing statutes and court decisions have not fully determined the legal meaning of a "tenancy in partnership," the partnership itself should not take title to specific assets except on the advice of an attorney.

As an alternative to the partnership assuming ownership of assets used in the business the partnership could lease needed real and personal property or the individual partners could agree to contribute the use of their personally owned property to the partnership business. In such cases each partner's property rights are limited to his interest in the partnership and his right to participate in the management of the partnership business.

A partner's interest in the partnership, which is his share of profits and surplus, is personal property and is subject to attachment or execution for claims against the partner. An assignment of this interest entitles the assignee only to the profits to which the assigning partner would be entitled.

These general rules may be varied by agreement between the partners.

Transfer of Property Belonging to the Partnership

The Uniform Partnership Act provides specific rules regarding the transfer of partnership *real* property.

If title to the property is in the partnership name ("tenancy in partnership"), any partner may convey title to such property by a transfer executed in the partnership name. The transfer is valid if the partner is acting under actual or apparent authority of the partnership and the buyers take the property in good faith. If the property is transferred in the name of a single partner the partner passes only an equitable interest (beneficial right) and not the legal title.

Where title to the property is in the names of all partners a transfer by all of them passes all rights in the property to the purchaser.

If the title is in the name of one or more but not all of the partners and the county records do not indicate that the property belongs to the partnership, the partner or partners in whose name the title stands may make a valid transfer unless the buyer knows that the property belongs to the partnership and that the partners have no authority to convey it.

When title is in the name of one or more or all the partners, or in a third person in trust for the partnership, a transfer by a partner in the partnership name or in his own name passes the equitable interest of the partnership. Again, provided the buyer does not know that the transferring partner is without authority to make the transfer.

Any one or more of the partners may be given the authority to transfer real property belonging to the partnership, either in the agreement or by consent of all the partners.

Each partner may sell *personal* property in the regular course of the business. However, where the purpose of the business does not include the selling of personal property but instead requires the keeping of property to stay in business this rule does not apply.

Liability of Partners

Each partner is an agent of the partnership and of the other partners. This includes authority to act as a representative of the partnership in carrying on the

business in the usual way. Outside parties dealing with a partner may assume the partner is acting in his capacity as an agent of the partnership. If the outside parties have no knowledge that the partner is acting without proper authority the partnership is bound by any agreements, contracts, or obligations entered in the partnership name, even if the partnership agreement expressly limited that partner's authority.

If the ordinary partnership does not have sufficient assets to discharge its legal obligation, each partner may be held personally liable for partnership debts and obligations. This does not include *personal* debts and obligations of the other partners. Personal creditors of a partner must collect their debt from such a partner or from that partner's share of partnership income.

A partnership is liable for loss or injury caused to any person, including employees, by the wrongful act or omission of a partner if he was acting in the ordinary course of the partnership business or with the consent of the other partners. Each of the partners is also individually liable for loss or injury if the partnership is liable. Because of possible personal liability, it is advisable for each partner to carry comprehensive personal liability insurance to protect himself against damage payments resulting from injury to third persons arising from acts committed by a partner or partnership employees.

Death or Retirement of a Partner

The partnership agreement should provide for the disposition of the property owned by the partnership if one partner dies or retires. Without such an agreement, the partnership must be terminated when a partner dies or retires.

A common way to provide for continuity of the partnership after one partner's death is the "buy-and-sell" agreement which is a contract between the partners for the purchase of a deceased partner's interest by the surviving partners. Such an agreement permits the business to continue and reduces the financial problems facing the widow of the deceased partner. Often such business purchase agreements include a life insurance provision which will assure funds to purchase the deceased partner's interest. Each partner to be insured is named, the amount he is to be insured for is indicated and the beneficiary designated in the agreement. The amount of insurance should roughly equal the value of the partner's interest in the partnership.

The agreement should specify who is to be responsible for payment of the insurance premiums and provide for acquiring additional policies of insurance if there is an increase in value of the partnership interests.

The method of valuation of a partner's interest at his death should be specified in the buy-and-sell agreement.

Some buy-and-sell agreements provide that the purchase price for a deceased partner's interest be paid in installments rather than in a lump sum. If profits appear large enough to pay the installments, the expense of insurance may be eliminated.

The installment method may also be used to purchase the interest of a retiring partner. Such an agreement can be an important source of retirement income and at the same time complete a gradual transfer of ownership to the next generation. Other provisions may be included in the buy-and-sell agreement as the parties desire.

Tax Considerations

The partnership itself pays no tax on its income although an information return is filed. Each partner is taxed on his share of the business income as determined by the partnership agreement. The partners include their share of the partnership profits as income on their own returns, whether that amount is actually distributed or is retained in the business. Partnership losses are likewise "passed through" to each partner and included on his individual return.

For income tax purposes, wage payments to partners must be treated as salaries and reported on the individual income tax return. The partnership is allowed to treat such payments as a partnership expense.

Gains or losses that are passed through to each partner retain their original character; thus capital gains, when "passed through," are still capital gains to the partner, capital losses remain capital losses and so forth.

In order to calculate capital gains or losses for tax purposes, a base value of a partner's interest in the business must be determined. This base value is called the "tax basis" and the partner's taxes are computed with this figure as a starting point.

The tax basis of an original partner's interest is his cash contribution, plus the adjusted basis he had for any property he contributed in setting up the partnership. If he buys into an established partnership his basis is his cash cost, plus his share of the partnership liability.

The tax basis of a partner's interest will change from time to time. It is *increased* by any subsequent contributions by the partner, by his share of partnership profits and by his share of any additional liability assumed by the partnership. Likewise, the partner's tax basis is *decreased* by distributions to him by the partnership of property or money, by his share of partnership losses, and by certain non-deductible expenditures. The basis cannot fall below zero.

It is important to keep track of the basis of a partner's interest in case of liquidation of the partnership or sale of the partner's interest. The gain or loss on the partnership operation is the difference

between the partner's share of money received on liquidation or sale and the basis for his interest in the partnership.

A partner may lend or rent property to the partnership. Such property remains the separate property of the individual partner and its sale and depreciation are reported on his personal income tax forms.

A partner may loan money or sell property to the partnership like any other person, providing such arrangements are formal and businesslike. However, if the partner owns more than 50 percent of the partnership, losses on sales or exchanges between the partner and his partnership are disallowed.

If a partner owning more than an 80 percent interest in a partnership realizes a gain on the sale or exchange of property with the partnership, capital gains may be treated as ordinary income in some cases.

Summarized above are only a few of the possible tax problems that may arise when operating as a partnership. Tax laws and regulations change from year to year. Be sure to rely on current tax advice when dealing with these and other tax problems.

Estate Planning

A partnership may offer estate planning advantages for some farm families. In some cases it can attract family members into the farm business, and provide continuity of ownership and retirement security. In addition, a partnership may be used to plan a reduction of Federal estate and state inheritance taxes.

One of the long range objectives may be to turn over the business to one or more children. If so, a partnership arrangement may provide the necessary inducements to attract and keep the children in farming.

It can provide a method whereby a son with little or no capital can contribute his services to the partnership and gradually acquire a greater interest in the capital of the partnership. As his management ability develops and his capital interest increases, the arrangement may provide for the young partner to receive a greater share of the profits.

The partnership agreement may also allow the father to retain management and control of the partnership until the son acquires business experience and proves himself capable. If this is desired, it should be clearly set out in the partnership agreement. Otherwise, each partner has equal management rights.

By use of a buy-and-sell agreement, discussed above, provision can be made for a partnership business to continue in operation upon the death or retirement of a partner. The buy-and-sell agreement can be made binding so that continuity is assured.

As indicated, the agreement can also provide for the purchase price of the deceased or retiring partner's interest to be paid in installments. This has the advantage of providing a continuous source of income to the beneficiaries of the deceased partner or to a retiring partner. Under such an arrangement the retired partner may continue to receive a share of the partnership profits in addition to the income from the sale of his partnership interest. Of course, his share of partnership profits would diminish each year as his capital interest in the partnership is reduced. Such an arrangement has an additional advantage in that the older partner's gross estate may be substantially reduced, thus reducing the eventual estate tax burden.

If the father is financially secure and therefore, in less need of retirement income, he may reduce his estate tax by making lifetime gifts of his partnership interest to family members. The gift tax provisions allow each married couple to make $60,000 in tax-free gifts during their lives. In addition to the lifetime exemption, a married couple may make up to $6,000 in tax-free gifts each year to each recipient. By transferring partnership interests to children in large enough amounts to take full advantage of the lifetime exemption and annual exclusion, a couple can reduce the eventual estate burden.

An estate plan will vary greatly depending on family objectives. A partnership may be used advantageously to accomplish some of these objectives for some farm families.

Legal assistance should be obtained to explore the possibilities of using a partnership in your estate plan. A well-drafted agreement will forestall many possible, complex problems.

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