

## Legal Aspects of Farm Partnerships

Stephen F. Matthews and Brian Griffith  
Department of Agricultural Economics  
College of Agriculture



In 1978, 10.8 percent of all farms in Missouri with annual sales of \$2,500 or more were operated as partnerships. In 1982, 9.9 percent of all farms in Missouri conducted business on a partnership basis, as did 13 percent of Missouri farms with annual sales of \$10,000 or more. As illustrated by these statistics, farm partnerships constitute a significant portion of the farm businesses in Missouri.

Missouri statute defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." [Missouri Revised Statutes, 1978, As Amended, 358.060]. Missouri case law has embellished this definition by describing a partnership as "a contract of two or more competent persons to place their money, effects, labor and skill, or some or all of them, in lawful commerce or business and to divide the profits and bear the loss in certain proportions."

### Key components for a partnership agreement

A partnership contract may be created either orally or by a written agreement. In some instances, it may be implied by acts and conduct of the parties. An attorney-drafted, written partnership agreement is recommended to prevent future misunderstanding between partners. No public filing of the partnership agreement is required under Missouri law.

The partnership agreement defines the organizational structure, capital structure, and tax considerations of the business arrangement. So the importance

of the way the agreement is drafted cannot be overemphasized. The following is a checklist of key components you should try to include in a partnership agreement:

- Name of partnership or partnership business;
- Address of principal place of business and any other business locations;
- Date of formation and, if known, date of termination of the partnership;
- Capital contributions made or to be made by all partners, listed by type and value;
- Any salary to be paid partners in addition to profit shares;
- Special business work assignments of partners, such as bookkeeper, manager, or purchasing agent;
- Procedure and requirements for sale, exchange, or liquidation of a partner's interest and for admission of new partners;
- Each partner's share of partnership profits;
- Any restrictions on any partner's authority to bind the partnership in business transactions;
- A list of all partnership-owned property and the source of the property, either contribution by partners or purchased with partnership funds;
- A list of property owned by partners separately and loaned to or used by the partnership;
- Bookkeeping and accounting methods to be used by the partnership;
- All income tax elections to be made by the partnership;
- Any special allocations of income tax deductions,

depreciation, credits, gains, or losses to be made to partners;

- Dissolution notice requirements;
- Whether a decedent partner's successor or estate may continue as a partner;
- Which partners' interests are to be wound up upon dissolution;
- Any buy-and-sell agreements, including authorization for purchase of insurance policies to fund the agreements and the method and conditions of use of insurance proceeds to purchase a deceased partner's interest;
- Liquidation procedures for termination of one or more or all of the partners' interests and for termination of the partnership; and
- Requirements and procedures for partners to continue the partnership business after dissolution.

Amendments or modifications to the partnership agreement are binding on all partners if all partners consent. However, amendments or modifications may be implied by consistent conduct which modifies or is contrary to the express partnership agreement.

## Registering the partnership name

If the partnership begins to conduct business under a fictitious name, it must, within five days, register the name with the Missouri secretary of state, together with the names and addresses of every person who is interested in or who owns any part of the business. Additionally, if the interest of any owner ceases to exist, or any other person or partnership becomes an owner, the fictitious name must be reregistered within five days.

## Each partner has an "interest" in the partnership

Once a partnership is formed, a partner may well ask, "Just what are my rights in this business? What do I own?" Simply stated, a partner's property rights in the partnership "are his rights in specific partnership property, his interest in the partnership, and his right to participate in the management." [Missouri Revised Statutes, 1978, As Amended, 358.240]. These rights are subject to modification in the partnership agreement, which means the partners could agree to different ownership rights.

As in any other form of business, partnerships have both real property (such as land and buildings) and personal property (such as equipment, grain, and livestock). Under Missouri statutory law, all property brought originally into the partnership business or acquired afterwards is partnership property. Unless an intention to the contrary appears (such as an express provision in the written partnership agreement), property acquired with partnership funds

is deemed partnership property. Real estate may be acquired and owned in the partnership name. Title held in this manner can only be conveyed in the partnership name.

In Missouri, a partner is a co-owner with his partners as a tenant in partnership of specific partnership property. Subject to any restrictions in the partnership agreement, partners have equal rights to possess and use the property for partnership purposes but have no rights to possess or use it for other purposes without the partners' consent. Nor is a partner's right in specific partnership property transferrable so that the transferee (such as a buyer or creditor) obtains the right to specific property as a partner. Nor can claims against a partner become a claim against his rights in specific partnership property.

A partner's interest in the partnership is his right to a share of the profits and surplus. This interest is personal property of the partner. Transfer by a partner of his partnership interest entitles the person to whom the interest is transferred to that partner's share in the profits.

Additionally, a partner's interest in the partnership is subject to attachment or execution for claims against that partner. Upon application to a competent court, a judgment creditor may be able to "charge the interest of the debtor partner with payment of the unsatisfied amount of such judgment debt with interest." [Revised Revised Statutes, 1978, As Amended 358.280]. This order is appropriately called a "charging order."

## Minors as partners

Having minors as partners may well create problems. Oftentimes, business and estate plans for farms may involve the transfer of partnership interests to minors. In Missouri, a person does not reach majority until his or her eighteenth birthday.

The minor may rescind the partnership agreement prior to reaching majority, thus enabling him to void possible personal liability to partnership creditors. Creditors might take a dim view of not being able to look toward a partner for remuneration if the partnership should default on its obligations. They may refuse or restrict credit to such partnerships. Additionally, an adult partner is unable to repudiate the partnership agreement, an obligation arising out of the partnership business, or the existence of the partnership on the grounds solely that a partner is a minor. Adult partners are liable; minors as partners can back out of partnership obligations if they so choose.

## Transfer of property

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.

If title to the property is in the partnership name ("tenancy in partnership"), any partner (unless restricted in the partnership agreement) 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), not 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 public records in the county where the partnership has its principal business do not indicate the real property belongs to the partnership, the partner or partners in whose name the title stands may make a valid transfer unless the buyer knows the real property belongs to the partnership and that the partners have no authority to convey it.

When the title is in the name of one or more or all the partners or in a third person's name 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. This assumes the buyer does not know the transferring partner is without authority to make the transfer. If he does know, no legal or equitable interest is transferred.

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

## Liability for another partner's acts

Generally, an admission or representation any partner makes regarding partnership affairs within his scope of authority can be used as evidence against the partnership. The partnership is also charged with knowledge of or notice to any partner of any matter relating to partnership affairs except where fraud on the partnership is committed by or with the consent of that partner. The partnership is liable to any person who is not a partner who suffers loss or injury due to the wrongful act or omission of any partner who so acts in the ordinary course of business of the partnership or with the authority of his copartners. Thus, each partner is unlimitedly liable for partnership obligations.

If the general farm partnership does not have sufficient assets to discharge its legal obligations, each partner may be held personally liable for partnership debts and obligations. This is called joint and several liability. This rule does not apply to *personal*

debts and obligations of the partners. Personal creditors of a partner must collect the debt from that partner or from that partner's share of partnership income via a charging order.

Each partner is an agent of the partnership for partnership business. Generally, anything a partner does during the normal course of business binds the partnership. However, if the partner who so acts has no authority in the particular matter *and the person with whom he is dealing knows the partner lacks authority*, the partnership may not be bound. Furthermore, the partnership is not bound if a partner acts outside the scope of the apparent partnership business, unless such acts are subsequently approved or authorized by all other partners. A partner's powers to act as an agent of a partnership may be restricted in the partnership agreement. Such restrictions are binding to all who actually know of them. Moreover, if *all* partners have not given authorization (or if the other partners have not abandoned the business), no partner can:

- Assign the partnership property in trust for creditors (on the assignee's promise to pay the debts of the partnership);
- Dispose of the good will of the business;
- Do any other act which would make it impossible to carry on the ordinary business of a partnership;
- Confess a judgment (such as a personal injury claim) against the partnership;
- Submit a partnership claim or liability to arbitration.

## Implied partnership

A person who is not a partner may be treated as such by a court to determine liability. When a person represents himself or allows another to represent him as a partner in an existing partnership or with one or more persons not actually partners, he can be held liable to those to whom the representation has been made and who has relied upon this representation and given credit to the apparent partnership.

## Joining an existing partnership

A person entering an existing partnership is liable for all the partnership obligations which arose prior to his admission. However, such previous obligations may be satisfied only out of partnership property, not out of the new partner's personal assets. An agreement could be made between the "new" partner, "old" partners, and "old" creditors whereby the "new" partner agrees to be held personally liable for the prior partnership debts. Partnership creditors, by their leverage over existing partners, may attempt to insist upon this when the partnership takes on "new" partners.

## Partnership books, inspection rights, and accountability

Unless stated otherwise in the partnership agreement, the partnership books must be kept at the partnership's principal place of business and every partner must have access to and may inspect and copy any of them any time. In order to prevent potential disagreements, the partnership agreement might provide for access to the books from, for example, 8 a.m. to 8 p.m. Monday through Saturday.

For a partnership to prove successful to all partners, there must be honest and open communication between them. Not only is this recommended, but Missouri law provides that, on demand, partners must render true and full information concerning all aspects of the partnership to any partner or the legal representative of any deceased or legally incompetent partner.

Any partner has the right to a formal accounting with regard to the partnership business: (1) if that partner has been wrongfully excluded from the partnership business or from possession of partnership property by the copartners; (2) if such a right is mandated in the partnership agreement; or (3) whenever the circumstances make such formal account just and reasonable [Missouri Revised Statutes, 1978, As Amended, 358.220]. An accounting is a statement of pecuniary transactions disclosing the business dealings of the partnership. This right for a formal account is actionable and may therefore be enforced through a court order if the copartners fail to comply with an accounting request.

## Fiduciary duty of each partner

Not only must any partner act honestly and openly with all others in the partnership, but he also has a fiduciary duty to the partnership. If a partner should acquire any profits from dealings related to the formation, conduct, or liquidation of the partnership or from use of partnership property without the consent of the other partners, the partner must account for any such benefit, and hold as trustee the profit obtained [Revised Revised Statutes, 1978, As Amended, 358.210].

## Continuity upon the death or retirement of a partner

The partnership agreement can contain provisions so the business may continue if a partner dies or retires. Otherwise, the remaining partners would be unable to continue the business and be forced to liquidate the assets of the partnership.

A common way to provide for continuity is the "buy-and-sell" agreement, a contract between the partners to purchase a deceased partner's interest. A

buy-and-sell agreement permits the business to continue and reduces the financial problems facing the survivors. Often such business purchase agreements include a life insurance provision that will assure funds to purchase the deceased partner's interest. Premiums are deductible business expenses to the partnership, and the policy beneficiary is the partnership. 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. It should also provide for acquiring additional insurance policies if the value of the partnership interests increases. 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 from partnership funds, 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. At the same time, it can 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.

Remember, if a partner dies or retires and his interest in the partnership thereafter ceases, the partnership must reregister with the secretary of state regarding the use of any fictitious name in the business.

## Dissolution of a partnership

A partnership is dissolved when the relationship of the partners changes because any partner ceases to associate in the business. That is distinguished from the winding up of the business. On dissolution, the partnership business is not terminated, but instead it continues until completion of the winding up of partnership affairs. The winding up of partnership affairs (called "liquidation" in legal terms) is the process by which all the partnership's business affairs are settled and partnership obligations satisfied.

Where there exists a partnership agreement, dissolution is caused:

- By the end of the definite time period or particular venture specified in the agreement;
- By the express action of any partner when no definite time period or particular venture is specified in the partnership agreement;
- By unanimous decision of those partners who have not assigned their partnership interest or allowed them to be charged for their personal debts, either prior or subsequent to the end of

- any specified time period or particular venture;
- By expelling in good faith any partner from the partnership under such power contained in the partnership agreement.

Regardless of whether there is a partnership agreement, the partnership will dissolve if:

- Any partner dies;
- Any partner or the partnership declares bankruptcy;
- A court so orders the partnership to undergo dissolution;
- It becomes unlawful for partnership business to be carried on or for the partners to continue the business as a partnership.

A court will order dissolution of a partnership upon application by or for a partner whenever:

- It is shown a partner is mentally incapacitated;
- A partner is in any way unable to perform his part of the partnership contract;
- A partner is guilty of such conduct which tends to prejudicially affect the affairs of the business;
- A partner willfully and (or continuously) breaks the partnership agreement or otherwise acts with regard to partnership affairs so it is not reasonably practicable to continue the business in partnership with him;
- It is shown that the partnership business can only be conducted at a loss;
- There exist any other circumstances that would make a dissolution of the partnership equitable.

Additionally, anyone who holds a partnership interest via a charging order or by an assignment may apply to a court for dissolution of the partnership if:

- The specified time period in the partnership agreement has expired; or
- The partnership was a "partnership at will" when the partnership interest was assigned or when the charging order was issued.

## Liquidation of a partnership

After a partnership is dissolved the next step is to discharge the liabilities and to distribute the assets if any remain. This process of winding up the business is known as "liquidation." The assets of a partnership are distributed as follows: **First**, to creditors other than partners. **Second**, to partners for their advances and loans made to the firm. **Third**, capital and investments to partners who made the contributions. **Last**, any profits left after all other liabilities are distributed to the partners on the basis of the agreement for sharing profits.

If the firm is insolvent, the debts of the firm may be satisfied from the personal sources of the partners in accordance with the agreement for sharing losses. When one member of the partnership dies, becomes incapacitated or otherwise disabled, the law gives the remaining partners the power to wind up the partner-

ship affairs. They, of course, must exercise reasonable business judgment on behalf of all partners and creditors.

Once a partnership is liquidated it is important that notice be given to outsiders, especially those who have previously done business with the partnership. This would involve notice by publication to all except outsiders who have done business with the firm. Such parties should receive actual notice so they will have no basis for believing the firm still exists. This avoids the possibility of partners continuing to be liable for indebtedness owing to such outsiders after the firm is liquidated.

## Income tax treatment

Although a partnership does not pay income taxes, it is required to file an information return each year (Form 1065). The partners are taxed individually on their distributive shares of partnership taxable income regardless of whether the income is in fact distributed. Their distributive shares pass to the partners through the partnership conduit with their original tax characterization, such as ordinary income, capital gains or losses, operating losses, investment credit, charitable contributions, dividends, tax exempt interest and soil and water conservation expenses.

The income tax regulations are many in number and technical in nature. The partnership and its partners should seek competent tax accounting and legal counsel to take full benefit of the rules even before forming a partnership.

## Social security and partners

A farm-partner's obligation to pay the self-employment tax to obtain potential social security benefits depends upon whether a partnership exists and what role the farmer plays in it. A partner in a general partnership would not pay the lower employee social security tax.

The basic rule is that a partner's share of the income earned by the partnership is to be included in that partner's net earnings from self-employment. When determining the individual taxable income for federal income and self-employment tax purposes, each partner must separately account for his distributive share of individual items of any partnership income, loss, deductions, and credits. Such distributive share represents the partner's net earnings from self-employment from the partnership.

Many types of income may be excluded from farmer's net earnings for self-employment purposes. Important types of income which are *not* to be included are listed below:

- Rent from real estate and personal property leased with real estate (whether the rent is

received in property, crop shares, or cash) are not included. In those cases where the landlord *participates materially* in the production or management of production of the farm commodity, such amounts are included in self-employment income. Material participation is more likely to be found under a crop share lease than a cash rental lease.

- Gain or loss from the sale or exchange of livestock held for draft, dairy, breeding, or sporting purposes and not held primarily for sale, is not included regardless of how long held or whether raised or purchased.
- Gain or loss from the sale or exchange of depreciable property, such as machinery, trucks, and equipment, used in the trade or business is not included regardless of the period held.
- Gain or loss from the sale of standing crops sold with land held more than one year is not included.
- Gain or loss from sale of timber which qualifies as a capital asset is not included. Gain or loss from cutting of timber that the taxpayer elects to treat as a capital gain or loss and gain or loss from the disposal of timber, coal, or iron ore held more than one year where an economic interest has been retained are not included.
- Gain or loss from the sale, trade, involuntary conversion (including certain casualty losses), or other disposition of property that is neither stock in trade nor held primarily for sale to customers is not included.
- Other capital gains and losses not previously mentioned are not included.
- Wages received as an employee are not included.
- Income from dividends on shares of stock are not included.
- Interest, unless received in the course of the conduct of a trade or business, is not included. An example might be interest received on accounts receivable.
- The net operating loss deduction is not included.
- The deduction for personal exemptions is not included.
- Periodic retirement payments to retired partners under a written plan of the partnership are not included.
- All other sources of income, gains, losses, or expenses, not resulting from the conduct of a trade or business, are not included.
- All nonbusiness deductions are not included.

Rental income (whether crop share or cash) is normally excluded from self-employment income if the landlord does not materially participate in the management or production of the farm commodity produced with regard to the property rented. However, if the landlord/partner renders substantial services, the rent payments may be termed guaranteed pay-

ments, and are considered part of the landlord/partner's distributive share of partnership ordinary income for federal tax purposes. Thus, these guaranteed payments can be included as a general partner's net earnings from self-employment. If an income tax loss for the partnership results from a partner's guaranteed payment, the partner's self-employment income is calculated by subtracting the partner's share of the partnership loss from the guaranteed payment.

Notice in the above exceptions that periodic payments made to retired partners pursuant to a written plan of the partnership are excluded from self-employment income. In this manner, older farmers who want to retire and maintain a steady flow of farm income may withdraw from the farm partnership and still receive payments from the remaining partners. The regulations allow retirement payments to be excluded from self-employment income if:

- The payments are made under a written plan which provides for retirement payments.
- The plan systematically sets forth a plan established for the purpose of making payments to retiring farmers.
- The payments are actually retirement income. According to the regulations, payments of benefits not usually included in a pension or retirement plan are not included, such as layoff benefits. Additionally, retirement eligibility is generally established on the basis of age, physical condition, and other factors normally associated with retirement.
- The plan provides that payments be made to all partners generally, or to a certain class of partners. Payments must be made on a periodic basis and continue at least until the partner dies.

However, given that the above plan meets the stated criteria, payments made to a "retired" partner may be deemed net earnings from self-employment if:

- The retiring partner performs services for the partnership in the year in which payments are made.
- In addition to hospital or retirement payments due the partner, other obligations exist between the partnership and the partner.
- The retiring partner still maintains a capital interest in the partnership during the year in which the payments are made.

Hence, a retired farmer/partner who maintains an active interest in the partnership risks including any retirement payments made to him from the partnership in self-employment income. That might cause a deduction in social security benefits.

Again, these rules are technical and somewhat confusing. It is best to seek tax counsel regarding self-employment taxes and their effect on active partners' earnings.

## 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 partner is financially secure and therefore, in less need of retirement income, he may make lifetime gifts of his partnership interest to family members. The federal gift tax provisions allow each spouse to make up to \$400,000 in tax-free gifts over the course of his lifetime if he dies in 1985, up to \$500,000 for death in 1986, and up to \$600,000 for death in 1987 and later. These figures represent the amount of gift tax that would be offset by the *unified credit* of \$121,800 available in 1985, \$155,800 in 1986, and \$192,800 in 1987 and later. In addition to the unified tax credit, a married couple may make up to \$20,000 in tax-free gifts each year to each recipient (up to \$10,000 per year per recipient where the donor is single).

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.

Get legal assistance 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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