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As farms grow bigger and taxes become higher and more complex, farmers are finding that careful estate planning is necessary to provide family security, a fair distribution of the estate, and maximum tax savings.

Whatever your particular estate-planning objectives, your success in achieving them may be influenced by the form of business organization under which you operate your farm. Although many successful farms are operated as sole proprietorships and a few of the larger ones are incorporated, you may find a partnership preferable in your particular situation. This type of organization offers many features which can be useful in operating your farm and in planning for your own and your family's future.

THE PARTNERSHIP IN GENERAL

A partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit." Compared with other forms of business organization, the partnership offers advantages as well as disadvantages.

On the plus side, the partnership provides an easy way for two or more individuals to pool their resources and conduct a farming operation under a democratic system of management. Less formal than a corporation, a partnership is flexible enough to permit easy adjustments to unexpected economic conditions. It can provide a convenient method for a farm owner to transfer property to his family. The partnership can be set up to continue after the retirement or death of a partner. Thus the farmer can be assured of an income after he retires. The partnership also permits death tax savings and may offer other tax advantages.

On the negative side, a partnership is dissolved upon the death of a partner unless the partnership agreement specifically provides for its continuation. Also, each partner has unlimited liability. Every partner is the agent of the partnership, and his acts, while carrying on the business of the partnership, bind the partnership. All partners are liable for the torts committed by any partner in the course of the business and are liable jointly for the debts of the partnership.

These possible consequences may well give a farmer second thoughts about becoming a partner with a son, son-in-law, or other family member who has not demonstrated mature business judgment. Before a father creates a partnership for estate-planning reasons, he
must consider whether the decision is wise in a general business sense. This involves careful consideration of each potential partner's abilities and disposition.

THE PARTNERSHIP AND FAMILY PLANNING

Your long-range objectives may be to attract a son or sons into the business, run the farm with them efficiently, gradually turn the business over to them, and finally retire with adequate and reasonably secure income. The family farm partnership is well suited to reach these goals.

Interesting a son in the business

A son who joins with his father in a partnership owns part of the farm business (but not necessarily any of the land) and is called a “partner.” Having an interest in the business, a voice in management, and the status of a partner may be the inducements that will keep him in farming.

Capital arrangements

To begin a partnership, each partner ordinarily agrees to make a capital or service contribution. The contributions need not be equal. In most father-son partnerships, the father is likely to provide most of the initial capital, with the son offering services as the major part of his contribution. The father will likely transfer a substantial amount of farm personal property to the partnership. Although he may also desire to transfer his real estate to the firm, it may be best at first for him to keep most of it in his own name and lease it to the business.

If the father feels that the son should have a capital interest in the partnership at the outset, he can give the son capital assets to be contributed to the business, or he can give a partnership interest itself. Before such gifts are made, however, the gift tax, if any, should be determined. The father should also carefully consider his own financial independence and security. He should not give property to his children with the expectation of getting it back in the future if he needs it.

Sharing profits

By agreement, the partners can share profits and losses in a ratio different from that of their capital contributions. The agreement may
be drawn to give the son a small interest in the profits at first, with gradually increasing amounts as he proves his ability and as he acquires a greater interest in the capital of the partnership.

**Managing the farm**

As with profits, management responsibility does not have to be turned over immediately to the son. Normally, a majority of the partners can control management decisions, and each partner has equal management rights. However, the partnership agreement may name one partner to exercise control over the partnership affairs. The father could thus retain management and control of the partnership until the son acquires business experience and proves himself capable.

Family members may be made partners even though they are not engaged in farming. For example, the father could make a married daughter and son-in-law partners for the purpose of sharing profits (providing capital requirements were met), but the partnership agreement could state that they would have no voice in managing the business.

**Transfer of interests**

A partnership interest can be easily transferred merely by assignment. The father may sell an interest to his son, or if the father is financially secure and wants to reduce his estate tax, he may give his son an interest. If the son is already a partner, no problem is raised by transferring an additional interest in the partnership to him.

It may not be so easy to transfer an interest to the son if he is not already a partner, particularly if there are non-family members in the partnership. No partner can be forced to accept another person as a partner. The mere assignment of an interest will not make the son a full-fledged partner unless the other partners agree. The son will have no voice in management; he will be entitled only to a share of the profits and a share of the assets on liquidation. In closely held farm partnerships, the original partners can avoid this problem by agreeing in advance that each partner may assign an interest in the partnership to his sons.

**Consolidation of Title**

Under the Uniform Partnership Act, land may be conveyed directly to and from a partnership. Also, one or more partners may be
given authority to buy, sell, or mortgage property for partnership purposes without the signature of the other partners. Partnership property can be used as security for loans without encumbering property of the individual partners.

There is another advantage in consolidating title in the partnership name. If the father wants to transfer part of the farm business to his children, he can simply assign to them that much of his partnership interest. Let's say, for example, that he wants to give 15 percent of the farm land and business to three children. If title to all the property is held in the partnership name and he owns all of the assets, he simply will assign each child a 5 percent interest in the partnership.

**PLANNING FOR CONTINUITY**

By advance agreement of all the partners, a partnership can continue after the death or retirement of a partner. Without such an agreement, the partnership must be terminated when a partner retires or dies. When a partner dies, the business is legally dissolved and the surviving partners are under an obligation to wind up the business and dispose of the assets or buy out the deceased partner's share and continue with a new partnership.

**The buy-sell agreement**

A common way to provide for continuity of the partnership after one partner's death is the buy-sell agreement, whereby the surviving partners are obligated to purchase the interest of the deceased partner. The agreement may either set a price, contain a formula for computing a price, or provide that the price be determined by a later appraisal of the assets. This method is more satisfactory than a provision giving the surviving partners an option to purchase the deceased's interest. The buy-sell agreement is binding and will insure continuity; the option is entirely discretionary with the surviving partners. In the case of a family farm partnership, the buy-sell agreement can be used to require that sons and daughters buy out the interest of any one of them that retires or dies.

There are two common types of buy-sell agreements. A cross-purchase plan bounds the partners as individuals to buy the deceased partner's interest. At the death of a partner, each of the remaining partners pays his share of the purchase price to the decedent's estate.
In most instances, the amount contributed by each partner will be in proportion to his share in the partnership. For example, X, Y, and Z are equal partners. The agreement provides that on the death of any partner, the remaining partners shall purchase the interest of the deceased partner for $100,000. Later X dies. Y and Z will then contribute $50,000 each, and X’s estate will receive $100,000 for X’s interest. Y and Z will then each own a half interest in the partnership.

In an entity plan, the partnership as an entity, rather than the individual partners, agrees to purchase the interest of the deceased partner.

**Funding the buy-sell agreement**

The major problem in connection with the buy-sell agreement is providing enough liquid assets to pay for the deceased partner’s interest. The problem is often solved with life insurance. In a small partnership, each partner takes out insurance on the lives of the others. Then, when a partner dies, the funds received from the policies are used to purchase his interest. Using the X, Y, Z partnership again, each partner would buy a $50,000 policy on the lives of the other two partners. When X dies, Y and Z would each receive $50,000 to pay for X’s interest.

When a partnership includes more than three persons, this cross-purchase insurance plan becomes difficult to handle. A five-man partnership would require 20 life insurance policies. In such a case, the entity approach, whereby the partnership buys one policy on the life of each member is usually better. When any partner dies, the partnership will use the proceeds to buy the deceased partner’s interest.

Despite the advantage of providing ready cash when a partner dies, the insurance method does present some problems. Whenever the parties are of different ages, adjustments may have to be made for differences in premium costs. One or more of the partners may even be uninsurable or insurable only at a very high cost. The total cost of insuring all the partners’ lives for a large enough amount to buy their interest may be a financial burden. Finally, if the partnership continues to increase in value, the policy may not pay enough to buy out the deceased partner’s interest.

As alternatives to insurance funding, the partners or partnership can set aside cash to pay for a deceased partner’s interest, or mix life insurance with other forms of investment.
Installment payments

The objectives of a partner’s estate plan may indicate that payment for his interest in the partnership should be spread over a period of time rather than made in a lump sum. In such a case, the buy-sell agreement can provide that the purchase price be paid in installments. The installment method makes it easier for surviving partners to pay for the decedent’s interest. If profits appear large enough to pay the installments, the expense of insurance may be eliminated. This method has the added advantage of providing a continued source of income to the beneficiaries of the deceased partner. Before the installment method is chosen, however, a partner should make sure that there will be enough liquid assets available at his death to pay death taxes and costs of administration.

The usual installment arrangement pays the beneficiaries a certain fixed sum each year until the partnership interest is entirely paid for. As an alternative, the agreement could provide for payment of a percentage of the partnership profits for a term of years. This arrangement has the advantage of relieving the surviving partners of a fixed burden to be paid each year. In addition, assuming that the partnership business is growing, the beneficiary will share in the increased profits that the deceased partner would have received had he survived.

One disadvantage of this arrangement is that the beneficiaries are subjected to the uncertainty of the firm’s future. In bad crop years they may get no payments at all. Realization of the entire value of the decedent’s interest would obviously depend on the continued success of the business.

Alternatives to the buy-sell agreement

As an alternative to the remaining partners’ buying out the deceased partner’s interest, the partners may prefer that their interests remain in the partnership after their death. This can be accomplished in two ways: (1) An agreement can give the surviving partners full use of the property and obligate them to pay a portion of the profits to the deceased partner’s beneficiaries. (2) The agreement can state that the decedent’s interest will remain in the business and the deceased partner’s executor, trustee, or other successor will serve as a partner.

In a family-farm partnership using the first arrangement, the father and son could agree, preferably as part of the partnership
agreement, that the son would have full use of the partnership property after the father's death. The wife, or other beneficiary, would not become a partner, but would receive a share of the profits for life.

This method of continuation is simple and may be desirable in a small family partnership; however, it has definite disadvantages. The decedent's interest continually depends on the success of the business — if the business goes bad, the decedent's estate may lose. In addition, if the partnership becomes insolvent, the creditors may attempt to recover from the decedent's estate even though the estate is not liable as a continuing partner. Another disadvantage is that if the estate keeps an interest in the business for too long a time, it may become burdensome and annoying to the surviving partners and even a drag on the business itself. This is especially true if the estate is subject to judicial supervision. Some of these disadvantages may be eliminated with a provision requiring the personal representative to withdraw from the business after a certain length of time.

Under the second arrangement suggested above, the partners would agree that when one of them dies, his interest would remain in the business. The remaining partners would form a new partnership with one or more of the deceased's heirs or other successors in interest. Although all partners must consent to the admission of a new partner, it appears that the consent requirement is met if the arrangement is provided for in the partnership agreement. However, since the courts are reluctant to force people into partnership with each other, they may not enforce the agreement if one partner raises objections to a proposed new partner.

PLANNING FOR RETIREMENT

Installment purchase of partnership interest

The present tax laws do not permit a partnership to provide many of the fringe benefits for retiring partners that are available for corporate officers. With careful planning, however, a good retirement program can be arranged which will provide security for a partner's later years.

The buy-out agreement using the installment method (page 8) can be an important source of retirement income. Instead of beginning when a partner dies, the installments begin when he retires. The payments usually are spread over 5 to 10 years, thereby easing the
burden on the remaining partners and providing a regular source of income to the retired partner. In addition to the income from the sale of the partnership interest, the retired partner may continue to receive a share of the partnership profits, although it will be diminished each year as his capital interest in the partnership is reduced.

This method is excellent for providing necessary retirement income and at the same time completing a gradual transfer of ownership to the next generation. If such a plan is adopted, it should be included in the partnership agreement in as much detail as possible. The partnership agreement should commit the parties to buying and selling rather than exercising an option, in order that the retiring partner can rely on this income. Leaving these matters “to worry about when the time comes” is to invite dissension among the partners.

**Commercial annuity plans**

Instead of receiving payments over a period of years under a buy-sell agreement, the retiring partner may, by previous agreement, receive his interest in a lump-sum payment at his retirement. He can use the proceeds to purchase an annuity to provide retirement income. This arrangement may benefit the retiring partner since he gets his money immediately and will not have to worry about the future of the business. However, unless the partnership makes adequate funding arrangements, it may be very difficult to pay such a large amount at one time.

**Lease of land**

Leasing the farm land to the partnership is another potential source of retirement income. The father or land-owning partner can choose to retain title to the land and then can continue to lease the land to the partnership after he retires. The rental will provide income to the father and mother for their joint lives, and the partnership can deduct cash rental payments for income tax purposes. The surviving parent could then devise the land to the children who are operating the farm as partners.

**Continue as inactive partner**

Another alternative is for the retiring partner to continue as a partner and draw a share of the profits. With this arrangement, he should have some kind of supplemental income that doesn’t fluctuate
— life insurance annuity, for example — so that he can maintain his living standard if partnership profits decline.

Paying income to an inactive partner may place an undue burden on the remaining partners. Since the inactive partner is not contributing any personal services, an employee may have to be hired, further decreasing the other partners’ income.

**Social security**

A final source of retirement income to be considered is social security benefits. The Social Security Act covers both farm employees and the partners. If a person contributes either services or capital and receives a share of the partnership profits, the proceeds are usually considered self-employment income, so that, if he makes qualifying contributions before retirement, he will receive social security payments after retirement.

**TAX ADVANTAGES**

**Income splitting**

It may be possible to reduce income taxes by dividing the business income among several family members so that the tax rates are lower. The partnership itself pays no tax; it only files an information return. Each partner is taxed on his share of the business income as determined by the partnership agreement.

In general, whenever capital is an income-producing factor in a partnership (as is true in a farm partnership), anyone who owns a capital interest will be recognized as a partner. It does not matter whether the interest was acquired by gift or purchase.

Certain requirements must be met, however, if a family partnership is to be recognized for tax purposes. To take advantage of income splitting, the donee or purchaser of the partnership interest must be the real owner of the interest and have control over it. Although the father may retain some control, such as making himself managing partner, the retained control must be for the benefit of all persons, not just for his own benefit.

If there is a bona fide transfer of a partnership interest, the receiving person will be recognized as a partner even if the motive for the transfer is tax avoidance. However, where the gift or sale is a mere sham or where the transferor retains too much control, he will continue
to be recognized as the owner. Tax regulations specifically state that “transactions between members of a family will be closely scrutinized,” and care should therefore be taken in meeting all the requirements of a valid gift.

A partnership may be formed with a very young child. According to the regulations, however, if the child is not old enough to manage his own property and participate in partnership activities, he will not be recognized as a partner unless his interest is controlled by an adult. Therefore, to take advantage of income splitting with a young child, the partnership interest should be transferred to a trustee for the benefit of the child or to the child under a guardianship.

For maximum tax savings, a separate trust should be created for each child. The trust method is more flexible than a guardianship and does not require periodic reports and court supervision as a guardianship does. Even though the interest is transferred to a trustee, however, the income will be taxed to the donor-father if it is used to provide the support for which the father is legally obligated. The donor (usually the father) must be paid a reasonable compensation for his services before any balance is distributed.

Reduction of estate tax

Gifts of partnership interests to family members may mean a substantial savings in estate tax. The gift tax provisions allow each married couple to make $60,000 worth of tax-free gifts during their lives. In addition to this lifetime exemption, a married couple may make up to $6,000 worth of tax-free gifts each year to each recipient. This yearly exclusion is noncumulative and must be taken advantage of each year, or it is lost. By transferring partnership interests to children in large enough amounts to take full advantage of the lifetime and yearly gift-tax exemptions, a couple can reduce the eventual estate tax burden. If partnership interests are given early in the life of the business, they generally will be worth less than if given later, and the potential gift tax liability is reduced.

Other tax advantages

Through planning, several other forms of tax savings are possible in a partnership. If the business results in a loss, for example during the early years or during a bad crop year, or if accelerated deprecia-
tion methods produce a tax loss and a cash gain at the same time, a partner may deduct his share of the losses from his personal income. An individual farm owner can do the same thing, of course, but if the business is incorporated, the stockholders may never be able to deduct some of the early losses unless a "corporation taxed like a partnership" is used.

A partnership is more flexible than a corporation for allocating income and expenses. For business reasons, the partners may not want to allocate income and expenses in proportion to capital investments. They may agree among themselves for special allocation of certain items as long as their purpose is not tax avoidance.

To a limited extent, a partner may also save taxes by selling appreciated capital asset property to the firm. He will pay a capital gain on the profit and the partnership will take a stepped-up basis for ordinary depreciation deductions. A sole proprietor cannot step up his depreciation basis.

In many respects, the terms of the partnership agreement determine the effect of the tax law on the partnership. Complex rules govern computation and allocation of income, determination of the basis of a partnership interest, recognition of gain or loss upon distribution of property, and treatment of transactions between the partner and the partnership. If the partnership form of organization is chosen, a competent attorney should be available for guidance and advice.

**DISSOLUTION AND LIQUIDATION**

Unless there is an agreement to the contrary, the partnership is dissolved by the death or retirement of a partner, at which time "the surviving partner or partners have the right, and are under the duty to wind up the firm business." Instead of planning to continue the business, the partners may decide to terminate it. For example, the children may feel that they cannot run the farm efficiently without the father, and that the assets should be sold or distributed.

If a buyer can be found, sale of the entire farm as a going business may bring a greater return than sale of the individual assets. The partners' gain or loss on the sale will be taxed at capital gain rates with the exception of receivables and inventory. The partnership itself pays no tax on the sale. Instead of selling the assets, the partners may prefer to receive the assets themselves in exchange for their part-
nership interests. In this situation, generally no income tax will have to be paid on gains until the property is sold.

On occasion, liquidation may be forced on the partners by a high estate tax burden of the deceased partner. On the death of a partner, there may be very few liquid assets (cash and marketable securities) with which to pay estate taxes and expenses of administration. In addition, the partnership may not have enough liquid assets to pay the deceased partner’s estate for his interest. In such a case, the administrator of the deceased partner’s estate may force the assets to be sold or distributed.

If liquidation becomes necessary, proper tax planning can reduce the burden. A partner realizes gain only if he receives money for his share of the business. Even then, he is taxed only on the amount by which the money received exceeds the adjusted basis of his interest in the partnership. The gain recognized will be treated as a capital gain. For example, Jones has a basis of $10,000 for his interest in a partnership. He receives $8,000 in cash, plus property valued at $3,000. No gain is recognized. However, if he had received $11,000 cash, $1,000 capital gain would have been recognized. If postponement of taxes would be helpful, the partners should make sure that money distributed to a partner does not exceed the adjusted basis of his interest. If necessary, excess cash should be invested in property and distributed in that form.

On the other hand, losses are recognized only if the partner’s interest is entirely liquidated and then only if the property that is distributed consists only of money, unrealized receivables, or inventory items. If it appears that the liquidation will result in a loss, the partners may benefit by converting the assets to cash so that the loss will be recognized for tax purposes.

One important objective of a farm partnership is usually to maintain the farm intact. With proper planning, the dissolution of the partnership need not result in a forced liquidation of the assets.

LIMITED PARTNERSHIPS

As an alternative to a general partnership, the father may consider a limited partnership with family members as the limited partners. A limited partner has a right to share in the profits and in the assets upon dissolution, but he has no voice in management. Limited part-
ners have limited liability; they are bound for partnership debts only to the extent of their investment.

The father may find that forming a limited partnership is the ideal way in which to split his farm income among minor children or children not wanting to participate in the farm activities. The father could donate or sell to his children an interest in a limited partnership, and this would entitle them to a share of the profits. Their rights would be limited to examining the books and records, giving advice, and becoming employees, provided such employment does not constitute management or control. The right to become an employee may be an advantage in that a limited partner could become eligible for employee fringe benefits such as pension and retirement plans, group life and health insurance plans, and bonuses.

Some requirements must be met to create a limited partnership. For example, just as in a general partnership, the donee of a limited partnership interest must have absolute control over his interest. If the father donates an interest, he must divest himself of all substantial control over it. Another requirement is that at least one general partner must have unlimited liability to creditors.

If a limited partner does exercise control in management decisions, he will become liable as a general partner. This stipulation would make it inadvisable for a father to make his grown son a limited partner, since the father probably would want the son to begin acquiring management experience. Other family members could be limited partners, however, and after retirement the father himself might wish to become a limited partner.

**DOES A PARTNERSHIP MEET YOUR NEEDS?**

As brought out in the preceding pages, a partnership offers advantages for some farm families. 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 taxes — income, inheritance, and estate.

If a partnership appears advisable in your particular situation, be sure to get legal assistance in writing a well-drafted partnership agreement. Such an agreement can forestall many complex property and tax questions.
For a general discussion of partnerships in the farm business, see Illinois Extension Circular 786. You may obtain a copy from your farm adviser or from the Information Office, Mumford Hall, College of Agriculture, Urbana, Illinois 61801.