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## **An Agricultural Law Research Article**

### **Formalizing the Farm Partnership**

by

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By C. Allen Bock\*

# Formalizing the Farm Partnership

## ARTICLE OUTLINE

- I. INTRODUCTION
- II. WHY FORMALIZE THE PARTNERSHIP AGREEMENT?
- III. THE PARTNERSHIP AGREEMENT: A SUGGESTED FORMAT
  - A. Preliminary Considerations
  - B. Capital Contributions
    - 1. *What Property Should be Transferred to the Partnership?*
      - a. *Non-tax Considerations*
      - b. *Tax Considerations*
    - 2. *Formalizing the Existing Partnership-Property Ownership*
      - a. *Real Property*
      - b. *Personal Property*
    - 3. *Tax Savings*
      - a. *"Capital Interest in a Partnership"*
      - b. *"Material Income Producing Factor"*
      - c. *Other Considerations*
      - d. *General Suggestions*
  - C. Operation
    - 1. *Management*
    - 2. *Partners' Powers and Limitations*
    - 3. *Distribution of Profits and Losses*
    - 4. *Allocations for Tax Purposes*
    - 5. *Capital Accounts*
  - D. Dissolution and Termination
- IV. CONCLUSION

## I. INTRODUCTION

The partnership is an elusive creature of the law whose characteristics defy uniform definition; its features adeptly change with its legal habitat. The veteran tax lawyer recognizes the partnership as including "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which

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is not . . . a corporation or a trust or estate."<sup>1</sup> Those familiar with the Uniform Partnership Act know the partnership as "an association of two or more persons to carry on as co-owners a business for profit."<sup>2</sup> Attempts have been made to confine the partnership to an ironclad definition of universal application, but the formulation of a precise definition of the partnership is impossible.

One suggested alternative is to list the usual consequences of the relationship if it is determined to exist. Advocates of this approach have observed that the partnership traditionally involves a sharing of profits and losses, a lack of centralized control, personal liability of members for partnership debts, equal rights among partners to participate in management, the ability of each member to bind the firm, and the common intention to carry on a business enterprise. But none of these consequences may be said to disclose in every instance the presence of the partnership,<sup>3</sup> and a partnership can exist without having all these characteristics.

In some respects, the partnership displays the attributes of the corporate entity; in other respects it resembles an aggregate of individuals secured only by the bonds of mutual agency. Both views are intermittently supported in the Uniform Partnership Act and the partnership provisions of the Internal Revenue Code. The partnership is an entity which may hold land in its own name<sup>4</sup> and must annually file a partnership income tax information return;<sup>5</sup> yet, the partnership is an aggregate of individuals who are personally liable for partnership debts and must individually pay tax on their separate distributive shares of partnership income.<sup>6</sup> Although the characteristics of the partnership may vary with its legal environment, its usefulness to the business planner is not diminished.

## II. WHY FORMALIZE THE PARTNERSHIP AGREEMENT?

Execution of a written agreement is not a prerequisite to the

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1. INT. REV. CODE 1954, § 761 (a) [hereinafter cited as CODE].
  2. ILL. REV. STAT. ch. 106½, § 6(1) (1971). NEB. REV. STAT. § 67-306 (Reissue 1971). "A partnership is an association of persons organized as a separate entity to carry on a business for profit." *Svoboda & Hannah v. Board of Equalization*, 180 Neb. 215, 142 N.W.2d 328 (1966).
  3. *Malvern Nat'l Bank v. Halliday*, 195 Iowa 734, 192 N.W. 843 (1923). This Iowa Supreme Court case was concerned with the existence of a partnership where a landlord and tenant cooperated in the operation of a farm business.
  4. NEB. REV. STAT. § 67-308(3) (Reissue 1971).
  5. CODE § 6031.
  6. *Id.* §§ 701, 704.

formation of a partnership.<sup>7</sup> “[T]hough easy to initiate, the partnership is not a particularly simple form of organization.”<sup>8</sup> The relationship among the partners and the internal structure of the enterprise may be anything the partners desire; their agreement, whether oral or written, is determinative and may produce a highly complex and sophisticated operational structure. When an express partnership agreement governing specific matters has not been entered into by the participants, the Uniform Partnership Act, as enacted by the state legislature specifies the rights and duties of the partners.<sup>9</sup> The Uniform Partnership Act is intended to dictate rights and duties concerning matters which the partners have not contemplated. A partnership, though deceptively easy to create, may develop during the years of operation into a highly complex business organization. For this reason reliance on the terms of the Uniform Partnership Act for resolution of future problems may be wholly unsatisfactory. Written formalization of the partnership agreement allows the partners to tailor their personal rights and duties on a wide range of matters.

Formalization reduces disputes among partners by making certain that each party understands and supports the major terms of the agreement. Although this may not persuade family members constituting a farm partnership that a written agreement is desirable, a formalized agreement is most useful in planning for unanticipated circumstances. The participants should, at the outset, determine the desired scope and duration of the partnership business and define the rights and responsibilities to exist among the partners. This will involve questions of management responsibilities (is management to be shared equally?<sup>10</sup>), authority (to what extent, if any, should a partner’s authority to act for the partnership be curtailed?<sup>11</sup>), and compensation (should the partners be paid a salary,<sup>12</sup> and how should the profits, losses, deductions, etc. be allocated?<sup>13</sup>).

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7. For statutory definitions of “partnership” consult ILL. REV. STAT. ch. 106½, § 7 (1971) or NEB. REV. STAT. § 67-308 (Reissue 1971) for checklists intended to determine the existence of a partnership. Also refer to J. Pennell & J. O’Byrne *Federal Income Taxation of Partners and Partnerships*, in ALI/ABA PRACTICE HANDBOOK, Ch. 2, 4-28 (2d ed. 1971). *Fougner v. First Nat’l Bank*, 141 Ill. 124, 30 N.E. 442 (1892). ILL. REV. STAT. ch. 106½, §§ 6, 7 (1971).

8. J. CRANE & A. BROMBERG, *LAW OF PARTNERSHIP* (1968).

9. ILL. REV. STAT. ch. 106½, § 1 *et seq.* (1971). NEB. REV. STAT. §§ 67-101 *et seq.* (Reissue 1971).

10. See Section III, C, 1 *infra*.

11. See Section III, C, 2 *infra*.

12. See Section III, C, 3 *infra*.

13. See Section III, C, 4 *infra*.

A written partnership agreement is necessary if the parties wish to tailor their agreement by displacing provisions of the Uniform Partnership Act. For instance, in the absence of an agreement the statutes control, and all partners share equally in profits regardless of individual capital contributions and no partner may enforce a demand for remuneration for services.<sup>14</sup> A formalized agreement is tangible proof and the best method for establishing and enforcing terms other than those embodied in the U.P.A. Further, a formalized partnership agreement is the most effective method to provide in detail for a partner's retirement or death and the acquisition of the deceased partner's interest by the remaining members. The partnership is a useful means for transferring the management and operation of a farming enterprise to younger family members, and by-sell provisions are frequently included in formalized agreements to facilitate this often difficult transition.

A carefully drafted partnership agreement may affect the impact of federal and state income taxes. Generally speaking, allocation among partners of partnership income, deductions, gain, loss, or credit may be controlled by the partnership agreement. If no applicable partnership agreement provisions exists, allocations are made according to the manner in which general profits and losses are shared by the partners.<sup>15</sup> Consider the following illustration of how this could result in unexpected inequities. Assume that A and B agree to work as partners. A contributes cash in the amount of \$10,000 while B contributes cattle worth \$10,000 but with a tax basis of zero. If the partnership subsequently sold the cattle for \$10,000, under the Uniform Partnership Act partner A would receive \$5,000 of the proceeds and pay one-half of the tax. A formalized partnership agreement could permit allocation of the pre-contribution appreciation in value to B and thus more fairly meet the expectations of the parties. One of the areas in which a planned written agreement is most critical is that of the family farm partnership where reduction in income taxes is possible through deflection of income. The existence of a written agreement clearly establishing the rights and liabilities of the respective partners, is one of the factors considered by the Internal Revenue Service ("Service") in recognizing the validity of income allocation to children.<sup>16</sup>

Determination of what constitutes a partnership asset is frequently difficult in the absence of a formalized agreement. A writ-

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14. ILL. REV. STAT. ch. 106½, § 18(a), (f) (1971). NEB. REV. STAT. § 67-318(f) (Reissue 1971).

15. ILL. REV. STAT. ch. 106½, § 18(a) (1971). NEB. REV. STAT. § 67-318 (Reissue 1971).

16. Treas. Reg. § 1.704-1(e) (2) (vi) (e) (1956).

ten agreement may answer a number of questions such as the precise capital contributions made to the partnership, whether property is being transferred, leased<sup>17</sup> or dedicated and the value of the contributed property, and whether property contributed by a partner subject to liabilities will result in a taxable gain upon formation of the partnership. Also, adjustments to the relative partnership interests for contributions as well as any intention that a partner not be repaid his contribution upon retirement, death, or dissolution should be specified.

Finally, a formalized partnership agreement not only provides a legal framework for the farm enterprise through which the expectations of the parties may be perpetuated, but also constitutes a comprehensive business plan with beneficial ancillary effects. A good accounting system is critical to the operation and management of any farm. A formal written agreement fosters the use of sound accounting practices and the compilation of complete and accurate financial records. Every attorney involved in farm tax work has experienced the haunting nightmare of attempting to recreate the records necessary to validate farm income tax returns. Equally important is the farmer's ability to assess the profitability of different crop rotation or livestock plans and then forecast the necessary cash expenditures to assure that profit. Likewise, when additional capital is needed, the ability of a farmer to produce the necessary financial papers on a regular basis may make the difference between acceptance or rejection of a loan application.

### III. THE PARTNERSHIP AGREEMENT: A SUGGESTED FORMAT

The agreement of the partners forms the basis for management and operation of the farm partnership.<sup>18</sup> It should be written, comprehensive, and detailed. Certain provisions are common to most partnership agreements and the remainder of this article will suggest what such provisions should contain and briefly discuss their purpose and ramifications.<sup>19</sup>

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17. If property is leased from a partner, the contents of the lease agreement should be set forth.
  18. In the absence of agreement between the partners, the statutory provisions control the operation of the partnership. See, e.g. ILL. REV. STAT. ch. 106½, §§ 44 *et seq.* (1971); NEB. REV. STAT. §§ 67-101 *et seq.* (Reissue 1971).
  19. Most of the sample partnership provisions used in this article were prepared by N.G.P. Krausz, Professor of Agricultural Law, University of Illinois, and are used with his permission. The clauses identified as being from the O'Byrne and McCord *Deskbook for Illinois Estate Planners* have been reprinted from *Deskbook for Illinois Estate*

### A. Preliminary Considerations

Before discussing the major portions of the partnership agreement, preliminary considerations such as the parties to the agreement, the name of the partnership, and its location, purpose and duration should be addressed.

#### Parties-Name-Location-Purpose

1. This partnership agreement entered into between \_\_\_\_\_ and \_\_\_\_\_ is hereby made effective as of \_\_\_\_\_, 19\_\_\_\_. All heirs, devisees, legatees, personal representatives and assigns of the parties to this agreement shall be bound by the terms of this agreement.
2. The name of the partnership shall be \_\_\_\_\_.
3. The principal place of business of the partnership shall be R.R. # \_\_\_\_\_, and at such other farms or places as may be agreed upon by the partners.
4. The partnership shall engage in the business of farming and raising livestock, together with all other business necessary and related thereto, as shall be agreed upon by the \_\_\_\_\_ partners.

As a general rule there are no statutory restrictions on what partnership name may be selected. In Illinois, a filing of the names of the partners is required only when the partnership name is unrelated.<sup>20</sup> In Nebraska the name must be filed in the office of the county clerk of the county in which the partnership's place of business is located.<sup>21</sup> A recorded certificate, stating the names and residences of the partners, the general nature and place of business, and the partnership name, is legal notice and evidence of the partnership's existence in Nebraska.<sup>22</sup>

Any lawful business purpose is permissible.<sup>23</sup> A broad statement of purpose is generally desirable so that the agreement need not be altered if related but unanticipated business activities are pursued. Under certain circumstances, however, a more restricted purpose clause may be desirable as one means of limiting the scope of a partner's actual authority to act for the partnership.<sup>24</sup> If the unanimous consent of partners is desired as a condition to expand-

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20. ILL. REV. STAT. ch. 96, §§ 4-7 (1971).

21. NEB. REV. STAT. § 67-101 (Reissue 1971).

22. Warren & Co. v. Martin, 24 Neb. 273, 38 N.W. 849 (1888).

23. ILL. REV. STAT. ch. 106½, § 31 (1971). NEB. REV. STAT. § 67-331 (Reissue 1971).

24. ILL. REV. STAT. ch. 106½, § 9(1) (1971). NEB. REV. STAT. § 67-309(1) (Reissue 1971).

ing the partnership business, a restrictive purpose clause should be employed.<sup>25</sup>

#### Term of Partnership

The partnership shall begin on \_\_\_\_\_, 19\_\_\_\_, and continue in effect unless terminated as hereinafter provided.

Alternate provision:

The partnership shall begin on \_\_\_\_\_, 19\_\_\_\_, and continue for \_\_\_\_\_ years, terminating on \_\_\_\_\_, 19\_\_\_\_.

Although individuals initiating a joint business venture usually intend it to continue indefinitely, there may be circumstances under which an agreement of only limited duration is anticipated, e.g., where joint farming is expected only for a few seasons. If a partnership continues after its stated date of termination, the rights and liabilities of the partners remain unaltered and the relationship continues as a partnership at will.<sup>26</sup> A partnership may be dissolved by a partner at anytime despite a longer stated period of duration.<sup>27</sup> If a partner deliberately dissolves a partnership before the end of an established term, the Uniform Partnership Act affords the other parties damages for breach of contract against the partner who wrongfully caused the dissolution. In such instances, the good will of the business is excluded when computing the value of the wrongdoer's partnership interest.<sup>28</sup> The parties could, of course, provide for an even more exacting measure of damages in the formalized partnership agreement.

## B. Capital Contributions

#### Capital Contribution by the Partners<sup>29</sup>

The initial capital of the partnership shall consist of the property contributed by the said partners as will be shown by a balance sheet which will be drawn as of \_\_\_\_\_, and which is at-

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25. See also ILL. REV. STAT. ch. 106½, § 18(h) (1971). NEB. REV. STAT. § 67-318(h) (Reissue 1971) states:

Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.

26. *Essay v. Essay*, 175 Neb. 689, 123 N.W.2d 20 (1963); NEB. REV. STAT. § 67-323 (Reissue 1971); ILL. REV. STAT. ch. 106½, § 23 (1971).

27. "Dissolution is caused . . . in contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time. . . ." NEB. REV. STAT. § 67-331(2) (Reissue 1971). See also ILL. REV. STAT. ch. 106½, § 31(2) (1971).

28. ILL. REV. STAT. ch. 106½, § 38(2) (1971). NEB. REV. STAT. § 67-338(2) (Reissue 1971).

29. O'Byrne and McCord, *supra* note 19, ch. 9, 21.

tached to this agreement. The signatures to this agreement and approval of this balance sheet shall constitute a transfer of said property to the partnership.

**Alternate provision:**

The Father and his wife and the Son and his wife hereby agree that the above-described real property and personal property as listed on the attached sheet, marked EXHIBIT A, are to be owned by this partnership, titles to be held in the partnership name, the Father and Son to have the interest of tenants in partnership in all such property. Said parties and their wives hereby agree to perform all acts necessary to transfer title to said property to the partnership name. Said wives sign this agreement as evidence of their consent to this provision.

**1. What Property Should be Transferred to the Partnership?**

Perhaps the most perplexing problem regarding the formation of a partnership concerns what property should be transferred to the entity. This discussion will analyze both the non-tax and tax considerations.

**a. Non-tax Considerations**

Partnership property consists of all property brought into the partnership or subsequently acquired on account of the partnership. The partnership may acquire any estate in real property in its own name, and title so acquired may be conveyed only in the partnership name. A conveyance of property to the partnership in the partnership's name passes the entire interest of the grantor unless a contrary intent is evident.<sup>30</sup>

Under the U.P.A. a partner is a co-owner with his partners of specific partnership property holding as a tenant in partnership.<sup>31</sup> Each partner acquires a right equal with other partners to possess partnership property for partnership purposes. If a partner wishes to use specific partnership property for a personal use, the consent of other partners should first be obtained.<sup>32</sup> A partner is not allowed by the U.P.A. to sell or pledge his tenant in partnership interest in specific partnership property unless all partners similarly dispose of or encumber their interests in the same property. An interest in specific property may not be transferred by a partner separate from his partnership interest. Thus, even though an individual

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30. ILL. REV. STAT. ch. 106½, § 8 (1971). NEB. REV. STAT. § 67-308 (Reissue 1971).

31. ILL. REV. STAT. ch. 106½, § 25(1) (1971). NEB. REV. STAT. § 67-325(1) (Reissue 1971).

32. ILL. REV. STAT. ch. 106½, § 25(2)(a) (1971). NEB. REV. STAT. § 67-325(2)(a) (Reissue 1971).

may hold a one-half interest in a feed barn as a tenant in partnership, the interest in the barn could not be sold independent of the partner's total interest in the partnership as a going concern.<sup>33</sup>

A partner's interest in specific partnership property lies beyond the reach of his personal creditors but is subject to attachment or execution on claims against the partnership.<sup>34</sup> When so attached or executed upon, the partner will be denied the shelter of the homestead exemption.<sup>35</sup> Although a partner's interest in specific partnership property may not be touched by his personal creditors, a receiver may be appointed by the court to collect the debtor partner's share of profits and other money due from the partnership.<sup>36</sup>

On the death of a partner his rights in specific partnership property vest in the surviving member(s) of the partnership; where the deceased was the last surviving partner, all interest vests in his legal representatives. Such surviving partner, partners, or legal representative, may possess the partnership property only for a valid partnership purpose.<sup>37</sup>

A particularly important consideration upon transferring property to the farm partnership is whether the partnership should own real estate. If substantial building improvements are present or contemplated, the transfer of the real estate with the present or planned buildings might simplify the accounting and operational aspects of the partnership. The estate administration of a general partner's interest, however, involves more difficult accounting, tax, and asset distribution problems.

Family considerations are also important. If the wife is a joint tenant or a tenant in common of the real estate, she may not be interested in contributing her interest in return for an interest in the partnership. Further, there are usually children in the family who are not interested in the farming business.

A lease<sup>38</sup> of the property to the partnership can guarantee a fair return to family members not interested in the farming enterprise (a fair cash lease provides the most simple arrangement).

33. ILL. REV. STAT. ch. 106½, § 25(2)(b) (1971). NEB. REV. STAT. § 67-325 (2)(b) (Reissue 1971).

34. ILL. REV. STAT. ch. 106½, § 25(2)(c) (1971). NEB. REV. STAT. § 67-325 (2)(c) (Reissue 1971).

35. *Id.*

36. ILL. REV. STAT. ch. 106½, § 28(1) (1971). NEB. REV. STAT. § 67-328(1) (Reissue 1971).

37. ILL. REV. STAT. ch. 106½, § 25(2)(d) (1971). NEB. REV. STAT. § 67-325 (2)(d) (Reissue 1971).

38. The author prefers a lease (instead of dedication) for both machinery and land if these assets are not transferred to the partnership. The legal status of a dedication is not clear.

If gifts to children are an objective of the parents, it may be more desirable to leave real estate out of the partnership. While gifts of partnership interests are possible, a gift to the non-farming children of a tenancy in common interest in real property is less fraught with potential pitfalls than the gift of the partnership interest.<sup>39</sup>

Tax consequences, both income and estate, should also be considered. The transfer of property to the partnership subject to an indebtedness may result in taxable gain to the contributor.<sup>40</sup> Within the context of estate planning, it may be desirable to transfer by gift property with a high basis. Thus, if one partner (e.g., father) owns property with varying tax bases he may wish to retain ownership of some high basis property outside the partnership with which to make lifetime gifts. Farm landowners near major metropolitan areas frequently experience rapid appreciation in property value due to subdivision or commercial development potential. To avoid further estate growth, this appreciating property could be immediately sold or given to younger family members.

Generally the transfer of machinery and livestock to the partnership is desirable. It is not necessary that the partners contribute the same amount (value or otherwise) of personal or real property to the partnership. As long as the property is accurately scheduled at the time of formation, the profit-loss split can be adjusted to provide for uneven contributions by the partners. One caution may be necessary; in Illinois, for example, partnerships and corporations are subject to personal property tax while individuals are exempt.

A reasonable alternative to the actual transfer that avoids the personal property tax problem is a lease of the personal property to the partnership. A lease does defeat the objective of transferring an interest in the farm machinery and livestock to a child or children through the sale or gift of a partnership interest. However, machinery and/or livestock could be sold to the children (perhaps on the installment basis), or a gift of certain machinery or livestock might be considered.<sup>41</sup>

Regardless of the final decision, a complete schedule of all the property being transferred to the partnership by each partner, along with the relevant tax information, is absolutely necessary for

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39. Dissolution is caused by the express will of any partner when no definite term is specified. No person can become a member of a partnership without the consent of all the partners.

40. CODE § 752(1) (c). See Section III, B, 1, b *infra*.

41. It should be noted, however, that a gift or sale would trigger investment tax credit recapture. CODE § 47.

proper tax, accounting, operational, and dissolution or buy-out transactions.

*b. Tax Considerations*

As a general rule, no taxable gain or loss is recognized to either the partnership or a partner when property is contributed to the partnership in exchange for a partnership interest.<sup>42</sup> There are, however, several exceptions to this general rule that will result in recognition at the time of transfer.

If the property contributed is subject to liabilities, (e.g., realty with an outstanding mortgage) the contributing partner is treated as receiving a cash distribution to the extent he is relieved of liability. If this amount exceeds the adjusted basis of his partnership interest, the excess will constitute taxable gain.<sup>43</sup> For example, assume that A and B form an equal partnership. A contributes property with an adjusted basis of \$100,000; the property has a fair market value of \$400,000 and is subject to a mortgage of \$250,000. A is relieved of a personal \$250,000 liability (deemed a cash distribution) but assumes a pro-rata share (one-half) of all partnership liabilities so is deemed to make a simultaneous cash contribution of \$125,000.<sup>44</sup> A is relieved of the liability to the extent of \$125,000. The excess of this amount over A's basis in the contributed property, \$100,000, is includable in income.<sup>45</sup> A's basis in the partnership would be the contributed property's adjusted basis in his hands reduced by the deemed cash distribution and increased by the deemed cash contribution. Because a negative basis is not possible, A's basis is zero.<sup>46</sup> B's basis in his partnership interest would be increased by \$125,000 (the deemed cash contribution incident to assumption of liabilities by the partnership). The allocation of partnership liabilities to the various partners is made in accordance with the ratios for sharing losses as formalized in the partnership agreement. Here, as in other areas, the existence of a written agreement is vital in determining the tax impact on the partners of a transaction.

A second exception to the non-recognition rule occurs when one partner receives an unrestricted interest in the partnership as compensation for services rendered. In this situation the interest is immediately taxable as ordinary income. In the absence of an agreement to the contrary, each partner is entitled to repayment

42. CODE § 721; Treas. Reg. § 1.721-1 (1956).

43. CODE § 752; Treas. Reg. § 1.752(i)(c) (1956).

44. *Id.*

45. CODE §§ 1221-23.

46. See CODE §§ 722, 752, 705.

upon dissolution for contributions made during the lifetime of the partnership.<sup>47</sup> If A is a 50 per cent partner in the A & B partnership for profits distribution purposes but has contributed 100 per cent of the capital, then absent an agreement A is entitled to receive his entire capital contribution before remaining amounts are distributed 50-50. To the extent that a contributing partner relinquishes repayment rights in the contributed property (as distinguished from a share in partnership profits) in favor of another partner as compensation for services, the latter recognizes taxable income under section 61 to the extent of the value of the acquired interest.<sup>48</sup> The tax impact of this "transfer" income may be reduced by imposing restrictions on the recipient's claim to the capital interest. Substantial restrictions may not only reduce the fair market value of the transferred interest but may also condition its alienability upon a future date and thus defer or spread out recognizable amounts.<sup>49</sup>

A third exception to the general rule emerges from the recapture provisions of sections 1245, 1250, 1251, and 38. For example, investment credit recapture is usually triggered unless substantially all of the assets necessary to operate the trade or business are transferred to the partnership. A careful study of the recapture provisions is necessary in connection with the partnership formation.

The contribution of property in return for an interest in the partnership should be distinguished from the sale of property to a partnership. In the first instance, consistent with the aggregate theory, the partner is seen as merely changing the form of his ownership. In the latter instance, consistent with the entity theory, there is a liquidation of ownership which is a taxable event. Section 707 governs transactions between the partnership and partners not acting in their capacity as partners, *i.e.*, non-contributors. Special rules have been enacted to deter manipulative transactions between partners and the partnership. Losses incurred by a partner will not be recognized if incident to a sale to a partnership by a partner possessing a direct or indirect interest in more than 50 per cent of the partnership's capital or profits.<sup>50</sup> If the partner owns an interest in excess of 80 per cent, capital gains treatment

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47. ILL. REV. STAT. ch. 106½, § 18(a) (1971). NEB. REV. STAT. § 67-318(a) (Reissue 1971).

48. Treas. Reg. § 1.721-1(b)(1) (1956).

49. Treas. Reg. § 1.721-1(b)(1) (1956); CODE § 83. See also A. WILLIS, PARTNERSHIP TAXATION (1971); PENNELL & O'BYRNE, *supra* note 7, at 32-36.

50. CODE § 707(b)(1).

may be denied and any gains treated as ordinary income. It is important to remember that for purposes of ascertaining ownership, the collateral, lineal, corporate, and fiduciary attribution rules of section 267(c) remain in full force.<sup>51</sup>

## 2. *Formalizing the Existing Partnership-Property Ownership*

Before the existing partnership operating without a written agreement can be formalized, difficult questions regarding what is and what is not partnership property must be answered. This can constitute a nightmare for the formalizing attorney. There are, however, some helpful guidelines.

### a. *Real Property*

Whether realty owned by one or all of the partners before the formation of the partnership remains individual property or becomes a partnership asset is largely a question of the intention of the partners.<sup>52</sup> The use of real property by the partnership alone is not conclusive proof of partnership ownership.<sup>53</sup> Likewise, legal title held in a partner's name is not conclusive evidence that the asset is not a partnership asset.<sup>54</sup> The use of partnership funds for payment of taxes, insurance or other claims against the realty has been considered by some courts to indicate an intention to treat it as partnership property.<sup>55</sup> Land held by the partners as tenants in common and treated as a partnership asset on the partnership books and in its income tax reports indicates that the land is in fact a partnership asset. Further support for such a finding is present if mortgages on such property are treated as partnership, not individual, liabilities.<sup>56</sup> Property acquired with partnership funds constitutes partnership property in the absence of an apparent intention to the contrary,<sup>57</sup> and the Nebraska Supreme Court has held that where property is sold and the sale proceeds are transferred to the partnership, partnership ownership is indicated.<sup>58</sup> The Illinois Supreme Court has held:

51. *Id.* §§ 707(b)(3), 267(c).

52. *Blakeslee v. Blakeslee*, 265 Ill. 48, 106 N.E. 470 (1914); *Nocross v. Ginery*, 181 Neb. 783, 150 N.W.2d 919 (1967) (concerning farming and livestock feeding businesses).

53. *Ellis v. Mihelis*, 60 Cal. 2d 206, 384 P.2d 7, 32 Cal. Rptr. 47 (1963).

54. *McGowin v. Robinson*, 251 Ala. 690, 39 So. 2d 237 (1949).

55. *Cyrus v. Cyrus*, 242 Minn. 180, 64 N.W.2d 538 (1954); *Riedeburg v. Schmitt*, 71 Wis. 644, 38 N.W. 336 (1888).

56. *Perelli-Minetti v. Lawson*, 205 Cal. 642, 272 P. 573 (1928).

57. ILL. REV. STAT. ch. 106½, § 8(2) (1971). NEB. REV. STAT. § 67-308(2) (Reissue 1971).

58. *Bode v. Prettyman*, 149 Neb. 179, 30 N.W.2d 627 (1948).

Where real estate is bought with partnership funds for partnership purposes and is applied to partnership uses or entered and carried in the accounts of the firm as a partnership asset, it is deemed to be firm property and, in such case, it makes no difference in a court of equity, whether the title is vested in all the partners or in one of them, or in a stranger, as the party holding the title is regarded as holding it subject to a resulting trust in favor of the firm furnishing the money, and while his duty may not be strictly that of a trustee, the rule applicable to fiduciary relations requires that he be not allowed to derive personal advantage from the use of the property.<sup>59</sup>

When an expenditure of partnership monies has been made to improve the realty of a partner prior to the formation of the partnership, courts have been more willing to infer that the partners intended the real estate to be treated as a partnership asset.<sup>60</sup> Additionally, where real property held in an individual partner's name is farmed by the partnership and no rent is paid or demanded by the partner, this too supports the conclusion that the land is partnership property.<sup>61</sup> However, the mortgage or conveyance by a partner of land owned by that partner but used by the partnership supports the conclusion that the property is not a partnership asset when done without acknowledgment of the partnership interest.<sup>62</sup>

When the only objectives of the formalization process are to reflect accurately capital contributions, determine basis for tax purposes, etc., and there is no disagreement among the partners, the statute of frauds does not pose a significant problem. The U.P.A. provides that property acquired with partnership funds is partnership property; title in the name of one or more partners is not controlling, and resulting and constructive trust theories may lead to an equitable circumvention of the statute.<sup>63</sup> Recognizing a division of authority, it has been stated: "[o]n the other hand, the better reasoned authorities hold to the view that land owned by a prospective partner at the time of the formation of the partnership does not become a partnership asset by a mere oral agreement of partnership even though such was the intention of the parties . . ."<sup>64</sup>

#### b. *Personal Property*

Many of the same factors and much of the reasoning applicable in the real property determination retain their judicial force when

59. *Einsweiler v. Einsweiler*, 390 Ill. 286, 291, 61 N.E.2d 377, 379 (1945).

60. Annot., 45 A.L.R.2d 1009 (1956).

61. *McNab v. Mills*, 199 Cal. 231, 248 P. 657 (1926). For a more detailed discussion of these and related problems, see J. CRANE & A. BROMBERG, *LAW OF PARTNERSHIP* § 37 (1968) and Annot., 45 A.L.R.2d 1009 (1956).

62. *Robinson Bank v. Miller*, 153 Ill. 244, 38 N.E. 1078 (1894).

63. ILL. REV. STAT. ch. 106½, § 8(2) (1971). N.E.B. REV. STAT. § 67-308(2) (Reissue 1971).

64. 49 AM. JUR. 2d *Statute of Frauds* § 218 (1943).

personal property is considered. Record title in the partnership name of motor vehicles, purebred cattle, checking accounts and other items would strongly indicate partnership ownership. The presumption regarding purchases with partnership funds remains applicable, and chattels, such as any piece of farm machinery, acquired by trading another partnership chattel would carry a heavy presumption of partnership ownership. The dedication of use or a lease to the partnership of personal property is possible and the intent of the parties in light of all surrounding facts and circumstances would be significant in determining whether there was a lease, dedication or transfer.

### 3. *Tax Savings*

The partnership is not taxed on income as an entity; rather it is treated as a conduit through which income is passed to individual members who are taxed in their respective brackets. This conduit principle may offer an attractive tax management device for the farming family. If the proper conditions exist, income may be diverted from a person in a high tax bracket (*e.g.*, a father) to an individual taxed at a relatively low rate (*e.g.*, a child). The tax effect of such a diversion is illustrated by the following example: Fred Farmer has an annual net profit from farming of approximately \$35,000 per year. His wife works in town part-time and her earnings equal all personal exemptions and itemized or standard deductions. The tax on \$35,000 on a joint return is \$9,920. Fred forms a partnership and transfers 20 per cent of the partnership business interest to each of two sons. The agreement provides that Fred is to receive a salary of \$15,000 a year and the balance of the partnership income is to be divided 60 per cent to Fred and 20 per cent each to the sons. Assuming all other facts remain the same, Fred is taxed on \$27,000 (\$15,000 salary plus 60 per cent of \$20,000 distributable income) and his tax will be \$6,740. Assuming each son has no other income and is single, they will each pay a tax of approximately \$548 on \$4,000 of income. The total tax on the \$35,000 of income equals \$7,836 compared with \$9,920 before forming the partnership, a tax savings of over \$2,000.

A variety of conditions must be satisfied before the Service will recognize the validity of a family partnership and its accompanying gain, loss, deduction, and credit allocations. Section 704(e) concerns recognition of family partnerships and provides that “[a] person shall be recognized as a partner . . . if he owns a capital interest in a partnership in which capital is a material income producing factor, whether or not such interest was derived by purchase or gift from any other person.”

a. "Capital Interest in a Partnership"

The mere right to participate in earnings and profits is not a capital interest in the partnership. Whether an alleged partner who is the donee of a capital interest in a partnership is the real owner of the interest and whether he has dominion and control over such interest must be ascertained from all the facts and circumstances of the particular case.<sup>65</sup> A number of factors have been identified as showing a lack of a complete transfer of dominion and control to the donee:

1. Retention by the donor of control over the distribution of partnership income.<sup>66</sup>
2. A restriction on the donee's ability to liquidate or sell his interest in the partnership at his discretion without financial detriment.<sup>67</sup>
3. Retention by the donor of the control of assets essential to the continued operation of the business (e.g., through retention of vital assets such as land or machinery which is only leased to the partnership).<sup>68</sup>
4. The donor should not retain management power or voting control which would hinder the donee in liquidating his interest at his discretion without financial detriment.<sup>69</sup>

Factors tending to show complete transfer of dominion and control are substantial participation by the donee in the control and management of the business, actual distribution to the donee partner of the entire amount or a major portion of his agreed distributive share of the business income for his unfettered use, and the holding out of the donee as an actual partner.<sup>70</sup>

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65. Treas. Reg. § 1.704-1(e)(2)(i) (1956).

66. *Priscoll v. United States*, CCH 1969 STAND. FED. TAX REP., U.S. TAX CAS. (69-2, at 85,383) ¶ 9536 (C.D. Cal. July 7, 1969). *But see* Treas. Reg. § 1.704(1)(e)(ii)(a) (1956) (partnership may retain income for the reasonable needs of the business).

67. Treas. Reg. § 1.704-1(e)(2)(ii)(b) (1956).

68. *Id.* § 1.704-1(e)(2)(ii)(c) (1956). "Presumably the leased property, even though essential to the partnership business, would be a retained control only if the lease were at will, for a short period of time, or cancellable at the will of the donor." WILLIS, *supra* note 49, at 537.

69. Treas. Reg. § 1.704-1(e)(2)(ii)(d) (1956).

70. *Id.* § 1.704-1(e)(2)(iv) through (vi) (1956). All the criteria indicate caution if minor children are involved. According to Treas. Reg. § 1.704-1(e)(2)(viii) (1956)

[a] minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by

b. *“Material Income Producing Factor”*

The interest owned in the partnership must be a “capital interest in a partnership in which capital is a material income producing factor.”<sup>71</sup> Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. Thus, if the operation of the business requires substantial inventories or considerable investment in plant, machinery, land or other fixed assets, capital will ordinarily be deemed a material income-producing factor. Capital is customarily not considered to be a material income-producing factor where partnership income is derived principally from fees, commissions, or other compensation for personal services performed by members or employees of the partnership.<sup>72</sup> It is not clear, however, whether capital is a material income-producing factor to the family farm partnership when substantially none of the land is conveyed to the partnership but rather the parent only dedicates the use of the land to the partnership. Although there are no cases on this point, it could be argued that the use of the land is not a capital asset to the business, and therefore any return on the land in excess of a reasonable amount for services rendered is income to the owner of the land and cannot be allocated to the other members of the partnership. To avoid this undesirable interpretation with the family partnership, the major portions of land and other property should be either conveyed or leased to the partnership where income shifting is an important consideration.

c. *Other Considerations*

Some final considerations involve compensation paid to the donor of capital for services rendered to the partnership, income attributable to donated capital, and inter-family purchases of partnership interest. Allocable partnership income may be determined only after reasonable compensation is deducted for services rendered to the partnership by the donor.<sup>73</sup> In determining what constitutes “reasonable compensation,” relative managerial responsibility and the cost of obtaining comparable services from one not possessing

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another person as fiduciary for the sole benefit of the child, and unless there is or could be such judicial supervision of the conduct of the fiduciary as is required by law. The use of the child's property or income for support for which a parent is legally responsible will be considered a use for the parent's benefit.

71. CODE § 704(e).

72. Treas. Reg. § 1.704-1(e)(1)(iv) (1956).

73. *Id.* § 1.704-1(e)(3)(i)(a) (1956).

a partnership interest should be considered.<sup>74</sup> Should compensation not be reasonable, the Service may reallocate income and deductions to reflect income more clearly or to prevent income tax evasion.<sup>75</sup>

Regarding the allocation of family partnership income, the donee of a capital interest must include in gross income his distributive share except to the extent that an allowance for reasonable compensation for the donor's services was not made and except to the extent that his distributive share attributable to his donated capital is proportionately greater than the distributable share attributable to the donor's capital.<sup>76</sup>

An interest purchased by one member of a family from another is considered to be created by gift from the seller; the fair market value of the purchased interest is considered to be donated capital. The "family" of any individual includes only a spouse, ancestors, lineal descendants, and any trusts for the primary benefit of such persons.<sup>77</sup>

#### *d. General Suggestions*

Before the family partnership agreement is formalized, the following suggestions regarding how to structure the partnership to best achieve tax recognition should be considered.

1. All partnership earnings should be distributed, at least annually, except for amounts retained for the reasonable needs of the business.
2. Buy-sell agreements should not require a sale by the donee at less than the fair market value of his interest.
3. The donee should be given the right to sell his interest and the right to demand liquidation of his interest after reasonable notice.
4. Unless the donee is a limited partner, he should be given express right to participate in substantial management decisions.
5. The donor should receive reasonable compensation for his services (either a fixed amount, a share of the profits, or as determined by the partners from time to time) before allocating income to partners according to their capital contributions.

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74. *Id.* § 1.704-1(e)(3)(i)(c) (1956).

75. *Code* §§ 61, 482.

76. *Treas. Reg.* § 1.704-1(e)(3)(i)(a) (1956).

77. *Id.* § 1.704-1(e)(3) (1956).

6. Any lease to the partnership by the donor of land or other assets essential to the farm should be long term, or grant renewal options to the partnership, and avoid provisions giving the donor enlarged powers over the leased property.
7. If minor children are partners, a limited partnership with the children's interest held in trust should be considered. It is not generally recommended that minor children be made partners. It is a rather cumbersome device solely for the purpose of deflecting income, but 16 or 17 year-old children with considerable maturity may be exceptions.<sup>78</sup>

### C. Operation

There are several aspects governing the operation of the partnership which should be formalized. These include the management of the business, the powers given to and the limitations imposed on the partners, the distribution of profits and losses and allocations of depreciation, depletion, and gains and losses among the partners, and the maintenance of capital accounts.

#### 1. Management

Each of the partners agrees to devote his time and best efforts to the partnership business and shall share equally in policy and management decisions.

Alternate provision:

1. Each of the partners shall have an equal vote in the management and policy decisions of the partnership business. Except as otherwise stated, all management and policy decisions shall be by a majority vote, each partner being entitled to one vote. (Such decisions include amount and kind of livestock, time of their purchase or sale, cropping system and crop rotation, participation in governmental programs for agriculture, major soil conservation practices, etc.)
2. Each partner shall devote substantially all his time, skill, and attention to the partnership business except that \_\_\_\_\_ and \_\_\_\_\_ shall not be required to devote their entire time or attention to the business of the partnership, but only such part thereof as they shall deem necessary or proper.
3. For the general conduct of the business, all partners shall be consulted so far as practicable; but for the purpose of harmonizing the policies and practices of the partnership and of securing uniformity and continuity in the conduct of its business, the general

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78. Follow-through in the operation is important. See WILLIS, *supra* note 49, at 551-53 for helpful suggestions in this regard. See also note 70 *supra*.

daily management decisions, except as otherwise provided in this agreement, shall rest in \_\_\_\_\_, herein referred to as managing partner.

In the absence of a specific agreement, all partners have equal rights in the management and control of the partnership business.<sup>79</sup> One partner cannot deprive another partner of his management rights even by court injunction.<sup>80</sup> The farm partnership business may be carried on most effectively if management duties are divided on the basis of each partner's interests and abilities. Consequently, specific provisions indicating the areas of responsibility and the decision making rights within each area should be included in the formalized agreement. If no agreement among the partners exists, any difference arising which concerns ordinary matters connected with the partnership business may be decided by a majority of the partners. The Uniform Partnership Act, however, does not allow any action to be rightfully taken in contravention of any agreement made by the partners without the prior consent of all of the partners.<sup>81</sup>

Several other aspects of partnership management should be placed in the agreement in particular situations. If the partners desire that certain ordinary matters connected with the partnership agreement be decided by a unanimous or greater than majority vote, the written partnership agreement should specifically describe such matters. Further, if the tax recognition of the family farm partnership is an objective, the management article of the agreement should be drafted in light of the earlier discussion and suggestions.<sup>82</sup>

## 2. Partners' Powers and Limitations

### Partners' Powers and Limitations

1. A partnership bank account shall be established and maintained at the \_\_\_\_\_ at \_\_\_\_\_.
2. Without consent of all the other partners no partner shall:
  - a. Make, execute, or deliver an assignment of partnership property for the benefit of creditors.
  - b. Contract to sell or lease all or substantially all of the property of the partnership.
  - c. Submit a partnership claim or liability to arbitration.
  - d. Confess a judgment against the partnership or any of his partners.

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79. ILL. REV. STAT. ch. 106½, § 18(e) (1971). NEB. REV. STAT. § 67-318(e) (Reissue 1971).

80. Hauke v. Frey, 167 Neb. 398, 93 N.W.2d 183 (1958).

81. ILL. REV. STAT. ch. 106½, § 18(h) (1971). NEB. REV. STAT. § 67-318(h) (Reissue 1971).

82. See Section III, B, 3 *supra*.

- e. Dispose of the good will of the business or do any other act that would make it impossible to carry on the ordinary business of the partnership.
- f. Admit a new member to the partnership.
- g. Act as surety, guarantor, or accommodation party to any obligation in the name of the partnership.
- h. Sell, mortgage, lease, or assign any partnership real property.
- i. Borrow or lend money on behalf of the partnership.
- j. Compromise any claim due the partnership.
- k. Hire or dismiss any hand or other employee.
- l. Contract or incur expenses or indebtedness on behalf of the partnership in any transaction involving more than \$.....

It may be advisable to limit the use of the partnership bank account for partnership income and expenses only. Personal funds and expenses too frequently are mixed in partnership accounts making accurate bookkeeping very difficult if not impossible. The Nebraska statute provides:

Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.<sup>83</sup>

Paragraphs 2(c) through 2(f) restate the Nebraska and Illinois statutes.<sup>84</sup> Paragraphs 2(g) and 2(h) are matters beyond the apparent authority of a farm business partner while paragraphs 2(i) through 2(l) restrict the partners in matters he does not have authority to exercise. Other necessary limitations may become apparent in the course of discussion among the prospective partners and should be included in the partnership agreement.

### 3. *Distribution of Profits and Losses*

#### Profits, Losses, and Salaries

1. The profits and losses of the partnership shall be distributable to the partners on the following basis:

|  |   |
|--|---|
|  | % |
|  | % |
|  | % |

Alternate provision:

83. ILL. REV. STAT. ch. 106½, § 9(1) (1971). NEB. REV. STAT. § 67-309(1) (Reissue 1971).

84. NEB. REV. STAT. §§ 67-309(3), 67-318(g) (Reissue 1971); ILL. REV. STAT. Ch. 106½ §§ 9(3), 18(g) (1971).

Each partner's share in profits and losses of the partnership shall be in the same proportion that the annual value of his contribution bears to the total annual value of all contributions to the business.

Absent an agreement to the contrary, each partner shares equally in the partnership profits and surplus remaining after liabilities are satisfied; each partner must likewise contribute toward partnership losses in accordance with his share of profits.<sup>85</sup> The decision concerning the division of profits and losses is not an easy one. Some relationship between capital contributions and profit sharing is reasonable, and the labor and management input of each partner is essential in determining the appropriate division. The special allocation of certain items of gain or loss may be achieved in the profit and loss article of the written partnership agreement or attained through use of a separate article.<sup>86</sup>

If the partners' interest in capital differ from their interest in profits, the partners should consider when the [formal] partnership agreement is being prepared, allocating any gain or loss attributable to the sale of a capital asset in the same ratio as their capital interests.<sup>87</sup>

Inclusion of a profit-loss statement may be helpful to the partners and avoid confusion about whether the profits are divided before or after the deduction for salaries.<sup>88</sup>

Salaries for acting in the partnership business are not allowed a partner in the absence of specific authorization in the partnership

85. ILL. REV. STAT. ch. 106½, § 18(a) (1971). NEB. REV. STAT. § 67-318(a) (Reissue 1971). See also Moldenhaver, *Formula and Non-Formula Systems for Distributing Partnership Net Income*, NEB. S.B.J. 20:261, Jan.-April, 1971.

86. See Section III, B, 4 *infra*.

87. WILLIS, *supra* note 49, at 31.

88. An example of such a profit and loss statement follows:

|   |          |          |
|---|----------|----------|
| <b>Income</b>                                   |          |          |
| Sales of products and services                  |          | \$ _____ |
| Sales of purchased livestock                    |          | _____    |
| Sales of breeding stock (capital sales)         |          | _____    |
| TOTAL SALES                                     |          | \$ _____ |
| Adjustment to sales (deduct)                    | \$ _____ |          |
| Cost or basis of purchased livestock            | _____    |          |
| Cost or basis of breeding stock                 | _____    |          |
| ADJUSTED CASH SALES                             |          | \$ _____ |
| <b>Expenses</b>                                 |          |          |
| Cash operating expenses                         | \$ _____ |          |
| Purchased feed                                  | _____    |          |
| Depreciation                                    | _____    |          |
| TOTAL FARM OPERATING EXPENSE                    |          | \$ _____ |
| INCOME BEFORE PAYMENTS OF SALARIES AND INTEREST |          | \$ _____ |
| Less salaries to partners                       | \$ _____ |          |
| NET DISTRIBUTABLE PROFIT OR LOSS                |          | \$ _____ |

agreement.<sup>89</sup> In the family partnership a written agreement is essential because compensation for services is a prerequisite to determining distributive shares of income. So long as payments made by a partnership to a partner for services are determined without regard to partnership income, such payments will constitute deductible business expenses.<sup>90</sup> The partner must, of course, include such payments as ordinary income. A guaranteed payment that is a necessary and ordinary expense is deductible, and if a guaranteed payment exceeds partnership income, the net operating loss must be allocated among the partners.<sup>91</sup>

A provision for a drawing account may be included in some agreements. Such an account would allow a partner to draw, in advance, against partnership profits. The drawing account, with specific amount limitations, may be more desirable than salary payments, especially when an operating loss may occur as a result of salary payments. An example of such a provision follows:

Each partner may withdraw from the partnership for his own use a sum not to exceed \$ . . . 200 . . . per month. This sum will then be offset against his distributive share for that year. If, on annual accounting, any partner has withdrawn in excess of his distributive share, he shall either refund the difference within 30 days of the annual accounting or not exercise his future withdrawal rights until such difference has been forfeited, whichever a majority of the partners shall require.

#### 4. *Allocations for Tax Purposes*

Any of an infinite variety of different special allocation provisions may be drafted into partnership agreements; each such provision must be specifically formulated to meet specific needs. Because of the particularity of these provisions, a representative sample is not presented.<sup>92</sup> Such provisions may be stated as a separate article in the formalized agreement or incorporated into the profit and loss provisions. The Code generally provides that in the absence of formalized and specific allocation provisions in the partnership agreement, items of depreciation, depletion, gain or loss with respect to contributed partnership property shall be allocated among the partners as if the property had been purchased by the partnership.<sup>93</sup> Specific items of partnership income, gain, loss, deduction or credit may be allocated in different ratios if the partners

89. ILL. REV. STAT. ch. 106½, § 18(f) (1971). NEB. REV. STAT. § 67-318(f) (Reissue 1971).

90. Treas. Reg. § 1.707-1(c) (1956).

91. CODE §§ 162(a), 707(c).

92. Sample tax allocation provisions may be found in WILLIS, *supra* note 49, at 565-70.

93. CODE § 704(c) (1).

agree upon such an allocation in the partnership agreement.<sup>94</sup> A written agreement best demonstrates such an intended allocation, but any such special allocation embodied in the partnership agreement may be disallowed if "the principal purpose . . . is the avoidance or evasion of any tax . . ." <sup>95</sup> The regulations chart a course to be followed in determining the "principal purpose;" six factors are considered:

1. Whether the partnership or a partner individually has a business purpose for the allocation.
2. Whether the allocation has substantial economic effect on partner's share of profit or loss independent of the tax consequence.
3. Whether related items of income, gain, loss, deduction or credit from the same source are subject to the same allocation.
4. Whether allocation was made only after the amount of the specially allocated item could reasonably be estimated.
5. The duration of the allocation.
6. The overall tax consequences of the allocation.<sup>96</sup>

Special allocations are most frequently used by the farm partnership to accommodate a disparity in adjusted basis and fair market value of individually contributed partnership property. Because the costs of growing crops and raising livestock are expensed (*i.e.*, taken as tax deductions) by cash basis farmers rather than capitalized (*i.e.*, added to tax basis), they usually carry over a zero tax basis to the partnership. Partners wishing to avoid equal allocation of items of income and expense on separately contributed property may provide in the partnership agreement for more equitable allocation of these items.<sup>97</sup>

## 5. *Capital Accounts*

### **Capital Accounts**

A capital account shall be maintained showing the ownership interests of each partner. The capital account of each partner shall consist of his original contributions at the start of this partnership plus any additional contributions and minus his share of partnership losses and of capital distributions made to him.

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94. *Id.* § 704(b) (1).

95. *Id.* § 704(b) (2).

96. *Treas. Reg.* § 1.704-1(b) (2) (1956).

97. *Code* § 704(c) (2).

Maintenance of a capital account, even though simple in accounting terms, is important. It enables the accountant to maintain the necessary records and provides essential information for the partners.

#### D. Dissolution and Termination

Dissolution technically occurs under state law when any partner ceases to be associated with the carrying on of the business, whether it be for reason of retirement, withdrawal, death or legal insanity.<sup>98</sup> However, dissolution does not necessarily force the termination of the partnership business. After dissolution, the remaining partners may wind up the business and liquidate, continue the business as a new partnership, or continue the business in a different form (e.g., sole proprietorship, corporation, etc.).

A primary objective of the family farm partnership is to facilitate continuation of the business on the death, retirement, or early withdrawal of one of the partners. If termination is not desired on dissolution, an agreement for continuation should be part of the partnership agreement.

##### Dissolution and Termination

Upon the death, retirement, incapacity or bankruptcy of a partner the remaining partners shall have the right to continue the partnership business. If they elect to continue the business, payments to the other partner or his legal representative shall be made as hereinafter provided.

Upon dissolution, other than by death, in a family partnership, the objective will probably be to permit one of the parties to continue the business as a sole proprietor. In this situation a provision in the formalized partnership agreement granting the non-dissolving partner the option to purchase the other partner's interest may be desirable. Such a clause should include a method for establishing value, a payment schedule, and a procedure to be followed if the option is not exercised.

A frequently encountered method for continuing the partnership after one partner's death is a buy-sell agreement whereby the surviving partners are obligated to purchase the interest of the deceased partner. Such an arrangement may set a purchase price, contain a formula for computation of a fair price, or provide that the price be determined by a later appraisal of the assets. The buy-sell method may be more satisfactory than a provision giving the surviving partners an option to purchase the deceased's interest.

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98. ILL. REV. STAT. ch. 106½, §§ 29-32 (1971). NEB. REV. STAT. §§ 67-329-32 (Reissue 1971).

The buy-sell agreement is binding, assures continuity (thus benefiting remaining partners), and may be made mandatory while the option is entirely discretionary with the surviving partners.

Funding poses the major obstacle to attaining a viable buy-sell arrangement. A cross purchase insurance plan might be available if all parties are insurable and the total cost is not an unacceptable financial burden. As an alternative, the buy-sell agreement may provide that the purchase price be paid in installments thus making it easier for surviving partners to pay for the decedent's interest. If partnership profits appear large enough to pay the installments, the need and expense of insurance may be avoided. Before the installment method is chosen, however, each partner should make sure that there will be sufficient liquid assets available at his death to pay federal and state taxes and the costs of estate administration.

Installment payment affords the beneficiaries of the deceased partner a continued source of income in future years. Further the installment buy-out agreement may provide an important source of retirement income if, instead of beginning when a partner dies, the installment payments begin when he retires. The payments usually are spread over a period of five to ten years thereby easing the financial 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 this distribution will diminish each year as his capital interest in the partnership is reduced.

When a partner leaves the partnership, valuation of his interest often creates thorny problems. The partners may establish in the partnership purchase agreement how and when the valuation is made. Periodically stated values (*e.g.*, determined at the end of each year), or perhaps the death tax value, may be used. If the parties want to be certain the contract price will establish the estate tax value, the option or contract price should be made binding during life. If a decedent is free to dispose of his interest at any price he chooses during his lifetime, price will be given little effect at death.<sup>99</sup>

#### **Effect of Dissolution by Death, Retirement, or Disability**

1. If this agreement is dissolved by the death of one of the partners, it is hereby agreed that the surviving partner may purchase the interest of the deceased partner by paying to the estate of said

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99. Treas. Reg. §§ 1.2031-3(c), 1.2031-2(h) (1956). On business purchase agreements generally, see O'Byrne & McCord, *supra* note 19, at ch. 804 and 810 which are excellent. Life insurance companies often provide valuable assistance and forms on business purchase agreements funded by life insurance.

deceased partner the clear market value of the total interest of said decedent as established under the provisions of paragraph \_\_\_\_\_. Said payment must be made within sixty days of the dissolution appraisal date or the right of said surviving partner to so purchase is automatically terminated. At the election of the purchaser, said payment may be made all in cash or not less than one fourth of said clear market value in cash and the remainder by the promissory note of the survivor, payable "on or before" three years from the date of its execution, with interest payable annually at \_\_\_\_% per annum upon unpaid balances, said note to be secured by no less than a second mortgage on the physical assets of the partnership.

The personal representative of the decedent is hereby authorized and bound to execute any instruments or do any other acts necessary or desirable to transfer or to evidence the transfer of the interest of the decedent to the surviving partner.<sup>100</sup>

2. Any partner may retire from the partnership as of the end of any year after giving the other partners at least three months' notice in writing of his intention to do so.

If any partner should retire from the partnership at the end of any year, his interest shall be purchased by the other partners at 100% of full value, but payments may be made in installments over a three-year period. If he shall leave within the first three years without consent of the other partner or partners, only 75% of this value shall be paid.

3. If any partner, because of disability or resignation, shall be unable to carry out his responsibilities for the remaining portion of any calendar year, the other partners may employ replacement labor for the balance of such year, and after a period of six months the cost of said labor shall be charged against the monthly sum paid to the partner unable to discharge this responsibility.

Any partner who shall be disabled so that he cannot perform his duties as a partner for a continuous period of six months may be retired from the partnership by a vote of all of the remaining partners.

The tax implications of purchase of a retiring or deceased partner's interest in a partnership by the remaining partner or partners should be remembered. All payments are considered as amounts realized from the sale or exchange of a capital asset<sup>101</sup> except unrealized receivables of the partnership and substantially appreciated inventory items. These last two items generate ordinary gain when liquidated.<sup>102</sup> The term "unrealized receivables" generally includes any rights to payment for goods delivered (or to be delivered) and services rendered (or to be rendered).<sup>103</sup> Inventory items are considered to be "substantially appreciated" if their fair market value exceeds 120 per cent of the partnership's

100. O'Byrne & McCord, *supra* note 19, at ch. 9, p. 27.

101. CODE § 1221.

102. *Id.* § 751.

103. *Id.* § 751(c)(1)-(2).

basis for such property and 10 per cent of the fair market value of all partnership property other than money.<sup>104</sup>

The partnership may file an election to adjust the basis of its property when a partnership interest is sold. This section 754 election triggers the provisions of both section 743 (optional adjustment to basis of partnership property) and section 734 (optional adjustment to basis of undistributed partnership property). The long range ramifications of a section 754 election must be studied prior to election.

#### IV. CONCLUSION

The partnership is an important business organization for the farm operation. Although not difficult in a drafting context, the formalization process demands a thorough knowledge of the Uniform Partnership Act and the relevant Internal Revenue Code provisions. Perhaps most importantly, it requires a fundamental understanding of the farm business and the goals and objectives of the prospective partners and their families.

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104. *Id.* § 751(d) (1) (A)-(B).