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Agricultural Limited Partnerships

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INTRODUCTION

The limited partnership as an organizational form for businesses in the United States has existed for quite some time.¹ Its use in farming or ranching operations, however, is newer. The limited partnership in agriculture came to be viewed by many as primarily a "tax shelter," and its use for that purpose did become more widespread.² With 1976 tax law reforms, the tax advantages of a limited partnership investment were diminished. Nevertheless, there is evidence to indicate that the limited partnership will continue to be used by a significant number of agricultural producers (see the survey results in part III). This issue of the *Minnesota Agricultural Economist* summarizes some of the factors that may influence the future use and development of the limited partnership in agriculture.

PART I: THE STATUTORY FRAMEWORK

Limited partnerships in Minnesota, whether in agriculture or another activity, are governed by the state's limited partnership act.³ The Minnesota statute and most others are patterned after the Uniform Limited Partnership Act (ULPA).⁴ The ULPA is a model statute first promulgated by a national commission in 1916, and revised in 1976. No state has yet enacted a limited partnership statute based on the revised ULPA model.

The definition of a limited partnership according to the Minnesota act is fairly straightforward: simply a partnership formed by two or more persons with at least one general partner and at least one limited partner.⁵ A "limited partner," as used in the act, is what is commonly known as a "silent partner." The limited partner's chief advantage is limited liability. The limited partners risk only their investment in the partnership, so their personal assets cannot be reached by creditors of the partnership. General partners, by contrast, are liable for any partnership debts to the extent of both partnership and personal assets.

No active role can be taken in the management of the partnership business, if the limited partner wishes to retain the protection of limited liability.⁶ Limited partners can become liable as general partners if, in addition to exercising rights and powers as limited partners, they take part in the control of the business.

The advantages of limited liability are apparent. The limited partner receives a degree of protection similar to that of a stockholder in a corporation. Farms or ranches operated as limited partnerships become more attractive to capital investors.

A certificate of limited partnership must be filed with the county recorder of the principal place of business.⁷ The certificate must contain basic items of information, such as the name, location, and purpose of the limited partnership, and its terms. The property or cash contributed by each limited partner must be shown on the certificate.

The revised ULPA, if it were to be enacted, would change these rules somewhat. All limited partnership certificates would be filed in the office of the Minnesota Secretary of State.⁸ This system of central filing would be similar to that presently mandated for corporations.

A more significant change proposed by the revised ULPA would allow a limited partner to contribute services.⁹ Present Minnesota law allows only cash or property contributions.¹⁰ The more liberal interpretation of allowable contributions under the revised ULPA would probably facilitate the formation of a limited partnership for some farm families. Certain family members wishing to be limited partners and having little cash or property may be in a position to contribute services instead.

PART II: CONSIDERATIONS IN THE FORMATION OF A LIMITED PARTNERSHIP

A number of factors influence the selection of the limited partnership as an organization form. For the farmer or rancher, it may represent a means of accumulating necessary capital or of

stabilizing income. Proper planning may yield certain income tax advantages for the producer and for family members participating in the partnership. For the investor, the limited partnership offers, in addition to limited liability, an opportunity to participate in the ownership of agricultural land. In states where corporate activity in agriculture is restricted (such as Minnesota), the investor may turn to the limited partnership as a potential alternative to the farm corporation. And certain tax advantages are still available to the investor in an agricultural limited partnership.

Capital accumulation

Technological development has increased the scale of agriculture through things such as computerized feedlots and broiler houses. Inflation has, meanwhile, pushed up the cost of many agricultural inputs. A farmer or rancher today may be in a situation where expansion is essential to remain competitive. The problem then is raising the necessary capital.

The limited partnership is one way of doing this. Limited partners provide the funds but do not control the business. This method of raising funds may be preferred by many producers to other more commonly used methods. Bank loans or cash advances from food manufacturers or processors may force conditions and restrictions on the producer that affect the management of the business. A farm or ranch operator may be able to raise the necessary capital, with greater freedom to manage the business, by forming a limited partnership.

Family tax planning

Not all limited partnerships involve outside investors. Many are composed of members of a single family. Typically, such a limited partnership will have as general partners the family members actively engaged in operating the farm. The family members not actively engaged in farming could be made limited partners. This would allow them an ownership interest in the farm, without any interest in the farm operation.

When a family limited partnership is formed, certain income tax problems can arise. If minor children are given partnership interests, the arrangement may be viewed by the IRS as an invalid attempt to transfer income from a parent in a high tax bracket to children who are normally in a lower tax bracket. The limited partnership must be carefully structured to avoid this.

A family member who receives a partnership interest as a donee (receiver of a gift) can qualify as a legitimate limited partner if certain conditions are met.¹¹ The transfer of property must be a bona fide transaction and the donee must be able to exercise control over the interest purportedly transferred. The limited partnership must be organized and operated in accordance with the state limited partnership statute. There should be no restrictions placed on the limited partner's right to sell or transfer this interest. A donor/parent should not attempt to exercise control over the interest of a donee/child. If these conditions are satisfied, then the fact that limited partners do not actively participate in the management of the partnership will not invalidate their partner status for tax purposes.

Estate planning

The farm or ranch limited partnership is often used as an estate planning tool.¹² It gives the producer flexibility in estate planning during the later phases of the farm life cycle. A family limited partnership can be appropriate for the farm family seeking to divide the ownership of the farm assets in an equitable manner while at the same time allowing the family members most actively engaged in farming to retain control as general partners.

Usually, the major farm assets are transferred to the limited partnership. However, the death of a general partner could force sale of these physical assets if liquid assets are inadequate to pay estate taxes. Life insurance policies held by the partnership on the lives of the general partners is one possible solution.

Limited liability

Limited liability can be a primary inducement for investors who have significant personal assets unrelated to agricultural production. Partnership or general partner assets may not be sufficient to cover contractual or tort

awards or settlements. Even insurance policies may be inadequate in such situations with the result being a bankruptcy. Where emergency funds are required, the value of limited liability is most apparent.

Limited liability protection may not be available to the limited partner in all situations, however. Creditors of the partnership, including some federal programs, might require the limited partner to personally cosign for certain loans and notes. This would eliminate the limited liability as to that contractual obligation.

Inflationary hedge

Limited partnerships benefit not only agricultural producers but also investors seeking a way to stay ahead of inflation, which currently exceeds the rate of return available on most reasonably safe investments. Land prices, by contrast, have generally kept ahead of inflation. Furthermore, agricultural land values have been augmented by tremendous increases in output per acre due to mechanization and improved fertilizers and pesticides. For these reasons, wealthy individual and institutional investors have become increasingly interested in agricultural land as a hedge against inflation. The limited partnership may be the most convenient way for these investors to obtain an ownership interest in agricultural land. At the same time, this avoids many of the problems associated with being the owner of urban property.

Alternative to corporate farming

For persons seeking an investment in agricultural land, the limited partnership is not the only alternative. Corporations are allowed to own farmland and engage in agricultural activities in some states, and the corporation offers limited liability similar to the limited partnership. However, many states have begun to greatly restrict corporate activities in farming. Some states, North Dakota is one, prohibit corporate farming altogether.¹³ Minnesota law prohibits most corporations from engaging in farming, although there is an exception for what is known as "family farm corporations," and some additional minor exceptions. It is not likely that outside investors could use these exceptions to any significant extent.

The restrictive nature of these corporate farming statutes may make the

limited partnership a reasonable alternative for these investors. The protection of limited liability would still be available. The limited partnership could turn out to be one way of avoiding the restrictions established by corporate farming statutes.

This use of the limited partnership could be curtailed by future legislative action. Iowa presently regulates limited partnerships in the same manner as corporations in regard to agricultural activity.¹⁵ Limited partnerships engaged in farming are required to file an annual report with the Secretary of State describing the extent of their land ownership.

If other states enact legislation similar to Iowa's, the number of limited partnerships engaged in agricultural operations could decrease. Iowa-patterned legislation may be enacted if the various states view the limited partnership as circumventing the intent of the corporate farming laws.

Tax considerations

The effect of income taxes is one of the most important considerations in determining whether a limited partnership will be the best organizational form for a particular agricultural entity. It is essential for the producer to know in advance how the IRS will treat any proposed partnership. The potential investors will also want to know what benefits or liabilities will accrue to them as a result of the limited partnership arrangement.

Usually, persons forming a limited partnership will want the IRS to treat them as a limited partnership. This status allows the earnings to be passed on directly to the partners and not taxed at the partnership level. This avoids the double taxation of income that occurs on corporate earnings. Both the corporation and the individual shareholder pay taxes on corporate income. It is important to many investors to structure the limited partnership to avoid corporate tax treatment by the IRS.

The tax classification of a limited partnership might be subject to interpretation because the term "corporation" is not precisely defined in the Internal Revenue Code (IRC). The IRC definition includes associations, joint-stock companies, and insurance companies.¹⁶ Some limited partnerships could be construed as "associations" within the meaning of the Code

and taxed as corporations. An organization will not necessarily be classified as a partnership for income tax purposes merely because it qualifies as a limited partnership under state law.¹⁷ The problem is to determine in advance whether a particular entity will be treated as a partnership or as an association taxable as a corporation.¹⁸

The IRS has issued a regulation that gives some guidance as to how a purported limited partnership will be treated.¹⁹ Normally, it will not be treated as a corporation unless it exhibits more than two of the following four corporate characteristics: (1) continuity of life, (2) centralization of management, (3) liability for debts limited to corporate property, and (4) free transferability of interests. Most entities organized according to the Minnesota limited partnership statute would not have more than two of these characteristics and therefore could avoid corporate taxation.

Revised tax shelter rules

Historically, one of the reasons for the popularity of the limited partnership as an investment has been its potential use as a tax shelter. As with most tax shelters, the primary purpose is to defer the taxation of income to later years. Shelters generally use a cash accounting method and create losses by accelerating deductions such as the depreciation of assets to the earlier years of the business.²⁰ These paper losses can be passed on to the investors or limited partners. However, recent changes in the IRC have diminished the attractiveness of the agricultural limited partnership as a tax shelter.²¹

Prior to the Tax Reform Act of 1976, limited partners were allowed to take deductions for losses suffered by the partnership. They could deduct up to the amount of their cash and property investments in the partnership plus their proportionate share of partnership debts. This allowed the partnership to pass on tax deductions that were larger than the amount the limited partner actually invested. The 1976 act changed this advantage by permitting the limited partners to deduct only an amount equal to the funds they actually have "at risk" at the close of the taxable year.²² This effectively limits the investors' deductions to the amount of their actual investment in the limited partnership.

PART III: MINNESOTA LIMITED PARTNERSHIP SURVEY

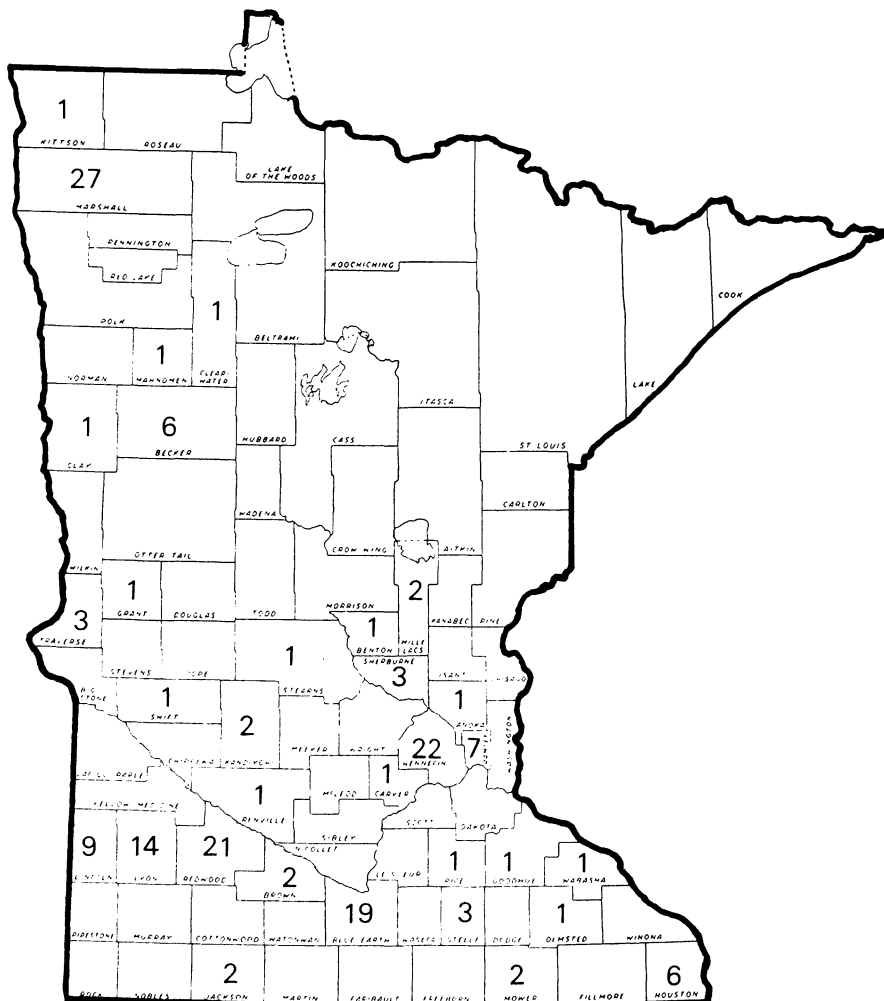
A survey was recently undertaken in Minnesota to learn whether limited partnerships were being used to any significant extent in agricultural operations. The county recorders were contacted and asked to report from their records on the number of limited partnerships that appeared to own agricultural land or to be engaged in farming or ranching. The county extension agents were asked to assist in the survey. A student researcher

surveyed the records for Hennepin and Ramsey counties. The results are summarized in figure 1.

A total of 174 limited partnership certificates were reported. Most of them appear to be engaged in the feeding of livestock or in the ownership of agricultural land.

A second part of the survey involved contacting selected attorneys in Minnesota likely to be involved in the formation or operation of agricultural limited partnerships. Six Minnesota counties were selected for this portion of the

Figure 1. 174 certificates of limited partnerships filed in Minnesota with county recorders in 1977 (counties without numbers either did not respond to the survey or indicated that no limited partnerships were registered)



survey. Geographic dispersion, types of agricultural production, and proximity to urban areas were considered in making selections (table 1).

Forty attorneys and law firms responded. Eleven indicated they had organized or advised agricultural limited partnerships and 19 limited partnerships were reported. The information indicated that estate planning considerations played the major role in the selection of the limited partnership form in 18 of these partnerships. In the remaining partnership, the desire for income stability was the primary motivating factor.

Thirteen of the 19 partnerships reported by lawyers were formed during 1977 or 1978. The limited partnerships reported by county recorders were also recently formed. This suggests that limited partnerships are still used in agricultural settings.

CONCLUSION

The limited partnership offers both potential benefits and disadvantages for the agricultural enterprise or investor. It offers flexibility as a business planning or estate planning device. Active managers control the business while other individuals maintain an ownership interest with limited liability. It offers simplicity with no board meeting, annual report, or record-keeping requirements. The tax ramifications for liquidation of the partnership are relatively simple. In some situations the limited partnership is viewed as an attractive alternative to the farm corporation, particularly in jurisdictions where corporate farming is restricted.

Disadvantages include the problem of the tax classification of the limited partnership. Care must be taken in the initial structuring of the organization. Even if the entity is characterized as a limited partnership for tax purposes, recent changes in the Internal Revenue Code have diminished some of the tax advantages previously available. Family partnership tax rules must be dealt with if close family members are given partnership interests. Finally, the future use of limited partnerships in agriculture may be affected if states decide to regulate them as they now do farming corporations.

Table 1. Survey of Minnesota attorneys, by county, May 1978

	Kandiyohi	Marshall	Mille Lacs	Houston	Watonwan	Lyon	Total
<i>Questionnaires:</i>							
Number of replies received	9	4	4	8	5	8	40
Number of positive responses ^a	2			5	3	1	11
Number of negative responses ^b	7	4	4	3	2	7	20
Total number of limited partnerships reported	3			10	5	1	19
<i>Number of limited partnerships by purpose:^c</i>							
Estate planning	3			10	4	1	18
Stabilizing income					1	1	2
Outside investors					1		1
<i>Number of limited partnerships by year of formation:</i>							
1978	2			4	2		8
1977	1			1	2	1	5
1970					1		1
Year unknown				5			5
<i>Number of limited partnerships by activity:</i>							
Grain only	3			2	2	1	8
Livestock only					1		1
Both				8	2		10

^aA positive response means that the attorney had organized or given advice to an agricultural limited partnership during 1970-1978.

^bA negative response means that an attorney indicated no assistance had been given in the organization or operation of an agricultural limited partnership during 1970-1978.

^cTotal number of responses add up to more than 19 because in some partnerships more than one organizational purpose was listed.

FOOTNOTES

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¹For a brief history of the development of the limited partnership in our country, see Shapiro, *The Need for Limited Partnership Reform: A Revised Uniform Act*, 37 Md. L. Rev. 544, 545 (1978).

²Some of the tax shelter aspects of this topic are discussed in S. Matthews and V. Rhodes, *The Use of Public Limited Partnership Financing in Agriculture for Income Tax Shelter* (North Central Regional Research Publication 223 [1975]).

³*Minn. Stat.* §§ 322.01 to .31 (1978).

⁴Uniform Limited Partnership Act (1916).

⁵*Minn. Stat.* § 322.01 (1978).

⁶*Id.* § 322.07.

⁷*Id.* § 322.02(2) (1978).

⁸Revised Uniform Limited Partnership Act, § 201 (1976).

⁹*Id.* § 501.

¹⁰*Minn. Stat.* § 322.04 (1978).

¹¹Treas. Reg. § 1.704-1(3)(2)(ix).

¹²The use of the limited partnership as an estate planning tool is examined in Hines, *Estate Planning for the Family Farmer and Rancher*, 10 Inst. Est. Plan. ¶ 301-308 (1976).

¹³*N.D. Cent. Code* §§ 10-06-01 to -06 (1978).

¹⁴*Minn. Stat.* § 500.24 (1978).

¹⁵*Iowa Code Ann.* § 172C.2 (West 1950 and Supp. 1979).

¹⁶IRC § 7701.

¹⁷Treas. Reg. § 301.7701-3(b)(1).

¹⁸For a more complete discussion of this topic, see Note, *Tax Classifications of Limited Partnerships*, 90 Harv. L. Rev. 745 (1977).

¹⁹Treas. Reg. § 301.7701-2(a)(1).

²⁰For a discussion of the tax shelter aspects of limited partnerships, see Note, *Tax Shelters: The Decline of the Limited Partnership*, 28 Corp. J. 99 (1978).

²¹Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976); Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978).

²²Pub. L. No. 94-455, § 304, *amending* IRC § 465.

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