AGRICULTURAL ADJUSTMENT UNIT | UNIVERSITY OF NEWCASTLE UPON TYNE

Organisational Possibilities in Farming and Types of Business Organisation

by M. A. Gregory & I. S. Stephenson

TP1A

THE AGRICULTURAL ADJUSTMENT UNIT
THE UNIVERSITY OF NEWCASTLE UPON TYNE

In recent years the forces of change have been reshaping the whole economy and, in the process, the economic framework of our society has been subject to pressures from which the agricultural sector of the economy is not insulated. The rate of technical advance and innovation in agriculture has increased, generating inescapable economic forces. The organisation of production and marketing, as well as the social structure, come inevitably under stress.

In February 1966 the Agricultural Adjustment Unit was established within the Department of Agricultural Economics at the University of Newcastle upon Tyne. This was facilitated by a grant from the W. K. Kellogg Foundation at Battle Creek, Michigan, U.S.A. The purpose of the Unit is to collect and disseminate information concerning the changing role of agriculture in the British and Irish economies, in the belief that a better understanding of the problems and processes of change can lead to a smoother, less painful and more efficient adaptation to new conditions.

Publications

To achieve its major aim of disseminating information the Unit will be publishing a series of pamphlets, bulletins and books covering various aspects of agricultural adjustment. These publications will arise in a number of ways. They may report on special studies carried out by individuals; they may be the result of joint studies; they may be the reproduction of papers prepared in a particular context, but thought to be of more general interest.

The Unit would welcome comments on its publications and suggestions for future work. The Unit would also welcome approaches from other organisations and groups interested in the subject of agricultural adjustment. All such enquiries should be addressed to the Director of the Unit.

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PREFACE

The Agricultural Development Association and the Agricultural Adjustment Unit are running a series of courses on various aspects of farm business management.

Several of the papers, prepared by specialists in their fields, deal with technical, legal and financial subjects in an authoritative way and are being issued as Technical Papers so that a wider audience than those attending these well-booked courses can benefit from the information which has been assembled.

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EDITOR'S NOTE

TP. 1A., as its numbering suggests is successor to TP. 1. It has two parts. The first has been prepared by Mr. M. A. Gregory who is a legal adviser with the Country Land Owners Association. This paper describes the various forms of business organisation. The second paper has been prepared by Mr. I. S. Stephenson who is a lecturer in law in the University of Newcastle upon Tyne. This paper discusses the different forms of business structure in detail. There is a little duplication of material but in view of the similarity of the topic it is felt appropriate that the two papers should be in the same cover.

ORGANISATIONAL POSSIBILITIES IN FARMING

M. A. Gregory

1. This paper is a lawyer's look at the possible legal structures for farm enterprises. The possibilities are looked at broadly in three main categories, namely, the landlord and tenant system, owner occupation, and joint enterprises.
I

I. LANDLORD AND TENANT SYSTEM

2. Since 1947 tenants of agricultural holdings have enjoyed statutory security of tenure. The governing Act is the Agricultural Holdings Act, 1948, which we shall call 'the 1948 Act' for short. The object of the legislation is to enable the farm tenant to keep a farming business on a long term basis, confident that he can expend money and plan ahead in the knowledge that he could only be displaced in exceptional circumstances. His security might be vulnerable to quirks of town and country planning or his own shortcomings (if any) but not the whim of his landlord. For his part the landlord receives a return on his investment and the agricultural holdings legislation aims to achieve a fair balance between the rights and duties of landlord and tenant during the tenancy, and to provide for an equitable reckoning at the end. The system gives farming opportunities to farmers or would-be farmers who own no land and have not the resources to acquire farms. Landowners, however, are becoming increasingly reluctant to tie their land with protected tenancies. The number of farms to let is always diminishing, while the number of prospective tenants is not. Further, according to Morris Cluttons' 'Agricultural Land as an Investment' (1969) farms are decreasing in number in this country by an average of 10 a day due to amalgamations.

3. What form is the farm tenancy likely to take?

4. Tenancy from year to year. The typical farm tenancy in England and Wales is the tenancy from year to year (or yearly tenency). It carries on until terminated by notice to quit given by either landlord or tenant, or until the tenancy is surrendered. Owing to statutory security of tenure, this tenancy is virtually a life tenancy, though if the tenant wants to give it up, he can do so by giving a year's notice to quit expiring on a term date of the tenancy (i.e. an anniversary of its commencement). If by mischance the tenant's security of tenure is brought to an end through no fault of his own, he will be compensated. From the landlord's point of view it is virtually a life tenancy because the only certainty in life is death, and so the only statutory ground for possession he can be sure to come his way will be the death of the tenant. There are other

grounds entitling the landlord to possession if they were to happen (e.g. planning permission granted for development) and there are discretionary grounds for which the Agricultural Lands Tribunal may consent to the operation of a notice to quit if they think it right to do so (e.g. sound estate management or bad husbandry).

5. Long leases. The other possible form of farm tenancy is the term of years - i.e. a tenancy for a fixed number of years, such as a seven years' tenancy. Here again the farmer has in effect security of tenure at least during his life-time, because the 1948 Act couples statutory security on to the end of the fixed term of years. The Act provides that a tenancy for two years or upwards shall not end when the fixed term is up, but will carry on as a protected tenancy from year to year.

6. There is little to be said for choosing a long lease for a farm tenancy in ordinary circumstances. There are drawbacks for both parties, but particularly for the landlord, especially if the tenant were to die before the fixed term of years expired. A long lease is like a play in two acts. Act I is the term of years fixed by the contract of tenancy. This is a period of inflexibility. The tenant will have no right to bring the tenancy to an end. At the best the parties will be able to serve notices to end the tenancy at 'break' periods, and if there is no 'break' clause they will have no right to serve notices to terminate the tenancy before the end of the fixed term. If the hero (the tenant) dies during Act I, the prospect for the landlord is that Act 2 will be interminable. The tenancy will become in effect a perpetual tenancy because his one and only certain ground for possession under the 1948 Act will never arise during Act 2, it being a biological fact that 'the tenant with whom the contract of tenancy was made' (the ground in section 24(2)(g) of the 1948 Act) will only die once.

7. Another drawback is that there is no statutory right of a rent review during Act I. This is because owing to its wording section 8 of the 1948 Act can only operate where a notice to quit can be served. Terms of years end 'by effluxion of time' and not by notices to quit. Leases should therefore have built in rent review systems of their own, unless the term is a short one, otherwise the rent will get out of date. A clause allowing periodical arbitration is, in my view, preferable to fancy devices such as gearing the rent to the price of grain in the local market or to published financial indices.

8. Tenancies of farming companies. One of the defects of the 1948 Act is that the landowner is discouraged from granting a tenancy to a farming company. The tenancy would be in effect a perpetual tenancy because a company, being at law a 'person' separate from its human constituents, will not die a death - i.e. the landlord's one 'certainty' will not come up. Even if it is in reality a 'one

man company', Farmer Giles Limited, it will live on when Farmer Giles dies. Devices less satisfactory than a direct tenancy to the company are therefore employed for the protection of the landlord's interest, such as granting the tenancy to a director in his personal capacity.

9. Tenancies of farming partnerships. The same problem does not arise in the case of tenancies to partnerships in England and Wales, because in English law a partnership is not a 'person' separate from the partners, and therefore the firm as such cannot hold a tenancy. Any tenancy granted would be to the individual partners as joint tenants.

10. Unprotected tenancies. Although the courts have never said so, it must be accepted that the parties cannot contract out of the security of tenure provisions of the 1948 Act. Any such agreement would undoubtedly be void, like agreements to contract out of the Rent Acts are. Many a farmer has agreed to take a tenancy for a limited period, undertaking to relinquish possession at a certain time, and has honoured the agreement. Such an agreement is no more than a 'gentleman's agreement' and therefore may be broken. If it is broken the landlord has no remedy and the tenant enjoys the full protection of the 1948 Act.

11. It is not possible to have a tenancy from year to year or any long term tenancy of an agricultural holding outside the protection of the Act, except that a sub-tenant is vulnerable if the head tenant succombs to a notice to quit from above. It is possible, however, to enter into certain short term tenancies - or tenancy like agreements, outside the grip of the 1948 Act. Tenancies or licences approved by the Minister of Agriculture (by way of Agricultural Executive Committees) under section 2 of the 1948 Act are without the Act. Owing to a misinterpretation of section 2 it has often been said that A.E.C's can only give approvals up to one year. Taken literally the abysmal wording of the section is near meaningless, but what is clear is that if the A.E.C. cares to treat the farming arrangement as a licence they can approve it for more than a year. Approval will of course only be given in special circumstances - e.g. where an owner occupier vendor is to be left in possession of a farm for a short while after the sale.

12. Quaintly enough, tenancies for a fixed period between one and two years are outside the 1948 Act simply because this loophole was left unintentionally by the draftsman. That the loophole exists was confirmed by the Court of Appeal in Gladstone v. Bower (1960) 3 All E.R. 353, a case of an 18 months tenancy. The tenancy ended automatically at the end of the 18 months period. The Government has announced its intention of stopping this loophole on the next revision of the legislation. Meanwhile it has been a convenient and legitimate means of letting farm land for short periods without troubling A.E.C's.

13. Leasebacks. The owner occupier needing liquid capital to inject into his farming business might find salvation in a sale and leaseback arrangement. Large investors have recently been seeing agricultural land as a sound investment, and it appears that three large firms of land agents have alone put through leaseback schemes in the last twelve months amounting to an investment of £16,000,000. Such investors may not be interested in an investment of less than £100,000, and as the purchase price will be at 15% to 20% below the vacant possession value of the farm, by and large owners of less than 300 acres need not apply. Leaseback opportunities must be looked at circumspectly. The landowners' sovereignty is not something to be given up lightly, and it must be remembered that the Mr. Four Percents in the City do not transact business out of philanthropy, but will be looking for a return nearer to 5%. The initial rent on the leaseback is therefore likely to be on the high side for an agricultural holding and the lease a full repairing lease to boot. The right of an owner occupier to dispose of his farm to his son or other relative will of course be lost and so will the 45% rebate on estate duty. On the other hand the purchase price will be realised at an equivalent of about $4\frac{1}{2}$% to 5% interest compared with an agricultural mortgage millstone of $10\frac{1}{4}$% at present. Occupation of the land will be retained with statutory security of tenure and a well endowed landlord.

II. OWNER OCCUPATION

14. This section examines some special arrangements where the landowner either farms the land himself, or arranges for it to be farmed while he retains occupation.

15. Vertical integration. Forms of vertical integration vary from a comparatively simple arrangement, as where a farmer grows seed under contract with a corn merchant, to an arrangement which is not primarily land based under which pigs or poultry are reared intensively and marketed under a mesh of contracts. In between there are contracts by farmers with, say, pea canners, under which the farmer is suppled with seed, is given technical direction and has the crop harvested and taken away. In all these cases the farmer is under what amounts to a management contract. He is paid to manage the production on his farm or premises. The risk to the farmer is reduced because his costs and returns are known in advance. Perhaps more important, in some instances, the whole project is financed by the other parties to the contract. An example of a contract was where the farmer provided poultry buildings of a stated capacity, took day old chicks from a breeder (a party to the contract), reared the chicks and supplied birds at a required weight to a grocery chain (another party to the contract). Food for the chicks had to be purchased from a stated supplier who was linked financially with the breeder, and no doubt the grocery chain was also. There are many variations on this theme and in the way the farmer's

remuneration might be fixed. From the farmer's point of view it is important that the obligations of all parties are made clear in his contract, and that the other parties to the enterprise fulfil their part efficiently and on time. He would also be prudent to see that the contract took account of set backs beyond his control, such as an outbreak of foot and mouth disease.

16. What of owners who are not experienced farmers but who want to make arrangements for farming their land efficiently without giving up possession?

17. Employment of farm manager. The farming responsibility can of course be left to an efficient farm manager. The farm manager will farm under a contract of employment and will not have the security of tenure of a protected tenant. This is clear from section 1(1) of the 1948 Act saying that the Act is concerned with 'land comprised in a contract of tenancy, not being a contract under which the said land is let to the tenant during his continuance in any office, appointment or employment held under the landlord', Where the manager was in no way a tenant there could be no question of the Act applying. His security will depend upon the terms of his contract of employment. In the case of Harrison-Broadley v. Smith (1964) 1 All E.R. 867 a farmer manager was held to have no claim to possession of the land on the termination of a partnership agreement between him and the owner under which he was to farm the land.

18. Employment of agricultural contractors. Schemes have been devised whereby the man responsible for farming the land for the owner is engaged neither under a contract of employment, nor a contract of tenancy, but as an independent agricultural contractor. He is paid a fee for undertaking the work and marketing the crop. Incentive to efficiency is injected into the scheme by making the amount of the fee vary with the profit,- subject to a guaranteed minimum payment. The agricultural contractor is self-employed in such cases, and the owner will have no responsibility for P.A.Y.E., national insurance, selective employment tax etc. The contractor will be responsible for his own tax and stamps, and will be eligible to recover S.E.T. paid in respect of his own employees. A typical form of this idea is the employment of a milking service. It is doubtful whether a large enterprise could be satisfactorily carried on by the employment of contractors.

19. Sale of grass keep. A grazier does not get statutory security of tenure under a grazing agreement if it is for 'some specified period of the year' and for grazing or mowing only (1948 Act, section 2). A period of 364 days counts as a 'specified period of the year'. There are only limited possibilities here for the owner who wants to retain control of the land. As buildings cannot be grazed or mown, farm buildings will have to be omitted from such agreements, though cattle shelters would no doubt pass muster, and if the grazier is to

plough and re-seed, the agreement would be brought under the umbrella of the 1948 Act unless he were employed to do it under a contract.

III. JOINT ENTERPRISES

20. In commerce, the professions and in industry outside agriculture business and professional men have for centuries formed partnerships and corporate bodies for their greater profit. Yet agriculture has been slow to accept the notion that several carrying on business in concert can do so for the greater benefit of each. The idea is now gaining ground and successful farming partnerships are evidence that the pooling of resources of capital, skill, 'know-how', contacts and experience can be beneficial.

21. Partnerships. Partnership law, being one of the branches of our law which has been codified, is largely governed by the Partnership Act, 1890. It is permissible, however, to contract out of a good deal of the Act and many of the sections begin, 'Subject to any agreement between the partners'. The Act starts with a definition of partnership as 'the relation which subsists between persons carrying on a business in common with a view of profit' (section 1(1)). What is often not realised, is that in English law a partnership firm is not a legal entity separate from the partners (though it is in Scotland). This has important consequences. A partnership is not like a company. All dealings by or with the firm are by or with the individual partners each of whom is an agent for the partnership. There is no limited liability (except in limited parnerships, see para 26 below) and each partner is liable for all the debts and obligations of the firm, and for any damages that can be claimed against any one partner for any wrongful acts or omissions in the course of the partnership business. A receiving order in bankruptcy counts as a receiving order against each partner. It will be seen therefore that as with other forms of marriage success will depend largely upon the compatibility of the partners.

22. Forms of farming partnership. There is little scope for partnerships between farm tenants, because normally it would be difficult or impossible to avoid breaches of tenancy - e.g. covenants personally to farm the land and prohibitions against parting with possession to others. Landlords are not likely to co-operate in overcoming the difficulties. They are more likely to be wary of extending security of tenure to joint tenants, and where joint tenancies are not envisaged they would be even warier of persons under no contractual obligation to them having use of their land.

23. On the other hand partnerships between landowners and farmers appear to be gaining favour. As an alternative to the ordinary farm letting to the farmer there can be distinct advantages for the landowner, and better prospects for

the farmer. There is sometimes an opportunity here for the farmer of promise who has insufficient capital to take a farm tenancy, yet if the circumstances are right he might get no less income out of the partnership business than if he had taken a tenancy, and he can be given the like security. The landowner will be taking upon himself a share of the farming risk which he would not have as a landlord, but by participating in the business can ensure that he will obtain earned income relief (provided he has not already the maximum benefit) whereas the rent from a tenancy would be unearned income. It is essential of course that the size and potential of the farm be such, that given the amount of capital which the partners are willing and able to put into the business, the farm is capable of rendering an adequate return to the partners. This may seem a statement of the obvious, but I have seem some extraordinarily optimistic partnership proposals.

24. Partnerships between owner-occupier farmers can often achieve a more economical use of capital and equipment than separate farming, and by sharing what each can contribute they can make the most of their land and other assets. There might also be advantages in marketing.

25. Partnership tenancies. This raises some interesting legal issues. In the first place there is no need for a farming partnership to hold a tenancy of the land it farms. If a tenancy is created it would have the advantage to the landowner's family that on his death the land will be valued without vacant possession for estate duty. In England and Wales the partnership firm as such cannot hold the tenancy, because it is not a separate legal entity. Any tenancy granted would be held by the partners as joint tenants. Although in Harrison-Broadley v. Smith (1964) 1 All E.R. 867 the Court ridiculed the notion, in fact the landowner, if a partner, can grant a tenancy to himself and other partners jointly provided the tenancy is in writing under seal. This is repugnant to the common law but clear from Law of Property Act, 1925, section 52, and the House of Lords decision in Rye v. Rye (1962) A.C. 496, which was not cited in the later case. As the tenancy is held by the partners as individuals the dissolution of the partnership will not of itself terminate the tenancy, and indeed the joint tenants will have security of tenure under the 1948 Act. Does this mean that on dissolution of the partnership an individual partner-tenant could claim to remain in possession with a protected tenancy? I think the better view is that he could not, unless there had been agreement to this effect. The tenants would hold the tenancy in the context of the partnership only and would be accountable to the partnership so lond as they held the land. This view is reinforced by the recent decision in Jacobs v. Chadhuri (1968) 2 All E.R. 124, in which the court held that after dissolution of a partnership one of the two tenant-partners could not claim a new lease of business premises (a theatre) under the Landlord and Tenant Act, 1954.

26. Limited Liability. A disadvantage of partnerships is the extent of the business risk falling to the individual partner. Any one partner may have to carry a can full of liability for the whole firm. It is possible, however, to have limited partnerships under the Limited Partnerships Act, 1907 under which one or more, but not all, of the partners may limit their liability to their contribution to the firm. The creation of limited partnerships in agriculture is not likely to become popular, because limited partners may take no part in the management of the business, and their income from it would therefore be unearned income. It is interesting to note, however, that limited liability could be achieved for all partners in spite of the rule that at least one partner must be a general partner - i.e. with full liability - by the general partner being a limited company.

27. Farming companies. Private limited companies are becoming less favoured for tax reasons. Since the introduction of corporation tax the balance of tax advantages and disadvantages would normally come down in favour of the formation of a partnership rather than a limited company. The overwhelming point in favour of a limited company is the liability of its shareholders being limited to the amount of their shareholding. There is also the greater ease in disposing of the shareholder's interest in the company compared with a partner's in a partnership, although because of this shareholders in a farming company may not be able to choose whom they will be associated with in the business.

28. Unlimited companies. Since the Companies Act 1967 there has been a temptation for limited companies to 'go unlimited', because section 196 of the Act requires the public disclosure of certain company affairs, including the directors salaries which hitherto were kept secret. This provision does not apply to unlimited companies. Nor does it apply to partnerships. Partnerships are not required by law to make an annual return of any kind. Farmers with farming companies who do not want their neighbours to know too much about their affairs might find it convenient to take advantage of the facility given by the Companies Act to go unlimited, but farmers starting a new joint venture would presumable take on the garb of a partnership rather than an unlimited company.

29. Co-ownership syndicates. There is a move afoot to organise investors into syndicates for the purpose of purchasing farms to be co-owned by the members of the syndicate. It is envisaged that each investor would contribute £10,000 to £50,000 each and the farm would be farmed by a tenant and managed for the syndicate by an agent. It is estimated that the investors would receive a net yield of 3% to 4% and that they could expect a substantial capital appreciation. Other attractions for potential investors are the agricultural rebate on estate duty, the section 134 allowance under the Income Tax Act, 1952 for improvements,

and the method of dealing with woodlands under Schedule B in respect of felling, and under Schedule D in respect of re-planting. As these advantages have drawn institutional investors into 'leaseback' arrangements of agricultural land, I can foresee the syndicates being popular with the rather smaller investors. From the farmer's point of view, he will be an ordinary tenant protected by the 1948 Act and a managing agent will represent his landlord. He may well be a some time owner-occupier who has undergone a sale and leaseback with the syndicate. Some of these syndicates may look for farms with deteriorated fixed equipment and take full advantage of the section 134 allowance.

30. Co-operation. The Central Council for Agricultural and Horticultural Co-operation has been set up under the Agriculture Act, 1967, to encourage co-operation in the industry and to administer grant aid. By aiding sound schemes the Council's work will undoubtedly lead to increased efficiency in the industry. At present the Council appears to be over much influenced by the Agricultural and Forestry Association Regulations made under the Agricultural and Forestry Association's Act 1962 for entirely different purposes (namely, to define bodies which would be allowed to indulge in restrictive practices without falling foul of the Restrictive Trade Practices Act). These are, however, early days, and no doubt the Council will prove flexible enough to iron out anomalies as they become apparent.

TYPES OF BUSINESS ORGANISATION

I. S. Stephenson

The purpose of this paper is to consider the various kinds of organisation which are in law available to the farmer and the main factors governing which kind of organisation he should establish. The paper takes as its starting point the farmer who is now the sole owner of his farm or the sole tenant of it, and who wishes to bring into his enterprise a member or members of the family, or other farmers or members of the public generally.

Although the main factors governing the choice of organisation will be referred to later in connection with each organisation in as much detail as is feasible in a paper of this nature, it appears convenient to state the really major factors at the outset so that these may be borne in mind throughout.

Freud regarded sex as the primary motivating factor in all human conduct. He did not live in Britain at the present day, otherwise he might have been tempted to change his mind and ascribe most human activity - or inertia - to tax. The legitimate avoidance of tax can be promoted as hindered by the type of organisation under which the farmer chooses to operate.

Next comes control - the management of the business. When a number of persons join in operating a business (other than as servants being directed by their master) it is necessary to have rules for deciding whose voice (or voices) shall prevail in the event of dispute, arising over the conduct of the business. And the greater the number of those engaged in the business, the greater the likelihood of divergence of opinion.

The third main factor is capital. Obviously a large scale enterprise may only be feasible by the infusion of capital from a number of individuals, the resources of each of whom standing alone would be insufficient for the purposes. The law lays down rules restricting the methods of entering into such a combination. The organisation may wish to borrow further capital upon the security of its assets, and here one type of organisation offers additional possibilities in this respect.

The last main factor is the extent of the liability of the participants for any losses made by the organisation. This liability may be unrestricted or limited to a certain maximum figure decided upon at the outset of the venture, depending on the type of organisation selected to carry on the venture.

With these factors in mind, we turn to discussion of the kinds of organisation which the law permits one to establish. Basically there are only two, partnerships or companies, but each of these contains subdivisions into different kinds of partnership and different kinds of company; one chooses the particular kind which one thinks is adapted to one's purpose. We first discuss partnerships, which can be divided into ordinary partnerships and limited partnerships.

Ordinary Partnerships

Partnership may be defined as the relation which subsists between persons carrying on a business in common with a view to profit. The maximum numbers of partners permitted by law is 20. (Companies, as we shall see later, allow a larger number of persons to be associated in the enterprise). This will be adequate except for big organisations requiring a very substantial capital. Common reasons for entering into farming partnership include a combination of two or more farmers desirous of sharing the use of expensive equipment, etc., or the introduction of a son or other member of the family into the business to enhance his status and interest and as a step towards reducing taxation. It must always be borne in mind as a cardinal principle of taxation in this country that tax falls most heavily on he who has a large income, or a large capital. The rate at which tax is levied on the income, or on each pound of capital, rises steeply until it amounts virtually to statutory confiscation of very large estates upon the death of their owners. But this levy is very onerous on estates which can scarcely be regarded as large; for example every £ by which a deceased person's estate exceeds £40,000 bears estate duty at a rate of 60% (subject to any special reliefs which might be available for some kinds of property which the estate might comprise. The solution is simple in principle, considering the tax aspect alone; the family cake must be carved into fairly even slices and distributed among the family. Thus

(a) If the income from the farm is high, surtax may be avoided by splitting it within the family - partners in the farming.
(b) Although the family, or some members of it, can be partners in the farming business without the land itself necessarily becoming part of the partnership assets, a transfer by the parent of part or all of the ownership of the land to the younger members of the family will avoid some or all estate duty on it at the death of the parent.

But the parent must survive the gift for a period of 7 years (with some relief after 4 years), so it is little use waiting to be notified by one's doctor that one has a serious disease before acting! The land can be conveyed into the sole ownership of the child (or children) and leased back to the partnership at a full rent, so that only the lease forms part of the partnership assets, or the owner-

ship of the land can be made an asset of the partnership, in which event each partner bears estate duty on his share of the assets.

There are disadvantages in that there will be legal costs and stamp duty on the transfer of the land, and capital gains tax on the disposal will also be attracted.

Formation of the Partnership

In law a purely verbal agreement suffices to create the partnership, but it would be most unwise (some reasons will appear later) to rely on such an agreement, and a solicitor should be employed to draw up a partnership deed under carefully considered instructions.

Transfer of Partnership Assets

The land, if it is to become partnership assets, can either be held by the original owner who in writing declares himself trustee of the land for the partnership, or the land can be conveyed to trustees (not more than four in number, who could be the partners themselves) to hold on trust for the partnership. If the partnership is merely to take a lease, the owner leases the land to trustees (as above) for the partnership.

Agency of the Partners

Anyone known to be a partner is presumed to have the authority of his co-partners to bind them to transactions which are in the ordinary course of the kind of business in question (e.g. purchase of livestock and machinery in a farming partnership). Thus one chooses one's partners with care, since one may find oneself in law committed to a purchase of which one disapproves and about which was not consulted. Moreover any clause in the partnership deed forbidding one's partner to act thus will have no effect on third parties who are ignorant (as will usually be the case) of the restriction, although breach of the contract of partnership will of course entitle the innocent partner to claim damage from the offending partner.

Implied rules governing the partnership

The Partnership Act, 1890, lays down many rules applicable to partnerships. It is most important, however, to grasp that most of these rules can (and sometimes should) be excluded by contrary clauses in the deed setting up the partnership. A selection of the most important rules now follows.

Partners share profits and bear losses equally (although their capital contributions may have been unequal).

No interest is payable to partners on their capital before profits are ascertained, but 5% interest is payable on any loan which, after the partnership has been created, a partner then makes to the partnership.

Every partner may take part in managing the business and inspect the books of the partnership.

Disputes concerning ordinary matters connected with the business are decided by a majority of the partners. But all must consent before the partnership business can be changed, a new partner introduced or a partner expelled.

A partnership can be brought to an end at any time by a partner giving notice of his desire to do so, and the death or bankruptcy of a partner automatically ends the partnership.

It may well, for example, be thought desirable to provide, contrary to the above rules, for interest to be paid on capital, where the capital contributions are unequal, before computing profits, and that there shall be no automatic dissolution on death and that a period of notice of intention to dissolve shall be given. ;

One may conclude that the partnership deed should deal with the following topics at least

(a) the nature of the business and the name under which the partnership chooses to trade. Any name may be chosen, but if the name does not consist of the true surnames of all the partners it must be registered under the Registration of Business Names Act, 1916.
(b) How the capital is to be contributed, and whether interest on it is to to allowed before computing profits.
(c) The banking account and who signs cheques.
(d) In what proportion profits (and hence losses) are to be divided.
(e) Who is to manage the business, and any restrictions on the authority of an individual partner (but see ante).
(f) Accounts.
(g) The duration of the partnership, including the effect of a partner's death and length of notice of dissolution.

It should finally be pointed out that each partner is personally liable to the full extent of his partnership or private assets for the whole of the firm's debts; he must look to his co-partners to compel them to bear their share and, should they prove insolvent, he will have to stand the loss himself insofar as he cannot get it from them.

This last consideration leads us to the other type of partnership:-

A limited partnership, formed under The Limited Partnerships Act, 1907.

This partnership must have at least one general partner who is liable without limit for all the partnership debts, but has one or more limited partners whose own liability is limited to the amount of capital which he has agreed to contribute. A limited partnership is created by filing with the Registrar of Companies a document stating, among other matters, the amount of capital which which the limited partnership is liable to contribute. 10/- per £100 capital duty is payable to the government on the capital sum for which the limited partner is liable. A limited partner cannot take part in the management (if he does he becomes liable for firm debts without any limit) and disputes relating to ordinary matters concerning the business are decided by a majority of the general partners.

Not many limited partnerships have been created in the past, mainly because a company could instead be formed under which all the members could (if so desired) take part in the management and yet all retain limited liability to contribute to the debts of the organisation. But in recent legislation most companies have been required to make their accounts available to the public, whereas partnerships are not required to do so, Hence it may be that limited partnerships will become more frequent, particularly when some of those associated in the venture are willing to undertake unlimited liability for its debts whereas others wish to restrict their liability.

Next we turn to companies. The first point to grasp is that a company when formed is a new and distinct legal person, entirely separate from its members, whereas a partnership is not a distinct legal entity but merely consists of the individuals who compose it. It follows that the company can own land, make contracts and has ah existence unaffected by the death of its members.

Companies can be classified according to the extent of the liability of the members to contribute to the assets of the company.

Thus we have:

1. Companies in which liability is limited by shares. The constitution of the company will state its maximum permissible capital, i.e. the number of shares and their value, say 100,000 shares value £1 each; there is almost completely free choice as to the number of shares and their value. Each member states how many shares he will take up and pay for, and payment of this sum to the company frees him from further liability, no matter what the debts of the company may be. Thus it behoves those trading with the company to ascertain what its capital is!

2. Companies in which liability is limited by guarantee. The constitution of the company will state how many members it will have, and each member will undertake to pay a specified sum (e.g. £100; any figure may be chosen) if needed to pay the debts of the company; having paid it he incurs no further liability. Such companies are usually formed for non-commercial purposes.

3. Unlimited companies. Here the members are liable without any limit to the full extent of the debts of the company. This is a great disadvantage if losses, seem fairly likely to rank as a possibility, but of little significance if one is virtually assured of profitable trading. If assured of regular profits, unlimited companies are advantageous in that they do not bear the 10/- per £100 duty on the company's capital which is exacted from companies limited by shares and limited partnerships, and they do not have to file accounts, as other companies must, with the Registrar of Companies which are open to inspection by any member of the public who cares to walk along to Companies House and pay a minute search fee. Hence some limited companies have recently converted themselves into unlimited companies.

Formation of the company

There are firms of lawyers who specialise in the manufacture of companies, and a company newly formed and ready to trade may be purchased from such a firm at a cost of around £35. However, it is often advisable to have a company with a constitution specially adapted to one's own particular requirements instead, and this will in practice require some additional legal expense. The company is actually created by filing certain documents with the Registrar of Companies and paying his registration fees and certain revenue duties. The most important documents are (a) the memorandum of assiciation. This contains primarily the company's name, the kind of business (or businesses) which the company intends to pursue, the capital of the company and the shares into which the capital is divided, and whether and if so in what way the liability of the members is limited. The memorandum must be signed by at least two persons (who will be the first members of the company) each of whom agrees to take and pay for at least one share in the company. It is thus a most important document. Two points are worthy of special note. Firstly, that the company must keep within its purposes as stated in the memorandum, and any purported contract outside those purposes is in law a complete nullity. The statement of the company's sphere of activity should therefore be wide enough to suit the wishes of the members. Secondly, the capital of the company can lawfully be fixed at any sum from say 1 shilling (2 members each of whom agree to take one share worth 6d.) to one million pounds. Thought should therefore be given to how much capital the company is likely to require (authorised or nominal capital - the maximum permissible) and how much of this the members are now

prepared to pay or undertake to pay by buying shares in the company now (the issued capital). These shares must be paid for either in cash or in money's worth, thus, for example, a farmer owning a farm worth £20,000 and livestock worth £10,000 might sell the farm and livestock to a company formed by him (with at least one other member) in return for 30,000 shares of £1 each. The land would be conveyed by deed to the company. He could if desired (e.g. to save estate duty provided he lives a good while thereafter) give away most of the shares to the younger members of his family. Once capital has been paid by the member to the company in return for their shares it is unlawful for them to take any capital back again out of the company except on dissolution of the company. The company uses the capital to finance its trade, and pays yearly (or more frequent) dividend to its members out of the profits of its trading. The member may, of course, sell his shares to a third party, (but see below) including another member for whatever price that person is willing to pay.

(b) The articles of association. These govern the internal working of the company, e.g. rules concerning directors and meetings.

(c) The statement of the nominal capital. Since stamp duty at the rate of 10/- per £100 is payable on this, it is advisable to restrict the nominal capital to what is necessary in the near future. The company can subsequently resolve to increase its capital, should this prove desirable later.

On receipt of these and other less important documents the Registrar of Companies will issue a certificate of incorporation which is conclusive evidence that the company is now in existence. Companies other than public companies (see below) may then commence trading.

How the company resolves to act

The company, as we have seen, is a distinct legal person from its members; such a person can only resolve to act through the agency of human beings. The possible organs for taking decisions within the company are

(a) the board of directors
(b) the managing director(s)
(c) the members of the company in general meeting.

The precise division of powers between these possible organs will depend on the terms of the constitution of the individual company. A private company must by law have at least one director, and a public company at least two. A sole director is likely to be willing to give full-time attention to the affairs of the company, but if there are several directors it is questionable whether all will be willing to do so, and in such a case a managing director may be appointed to work full time and be paid a salary commensurate with his labours, leaving

the larger board of directors to meet, say, monthly to take major decisions (by majority vote) and investigate progress.

The company must by law convene an annual general meeting of its members, and may convene other general meetings as and when required. The decisions of the general meeting are arrived at by resolutions of the members as to what shall and shall not be done. For most resolutions simple majority of those voting suffices, but the constitutions of the particular company could require a 3/4 majority of those voting, and for certain matters (e.g. to alter the articles of association) the Companies Act, 1948, requires this larger majority. Voting is initially by show of hands, with one vote per member voting, but in general a member dissatisfied with the result may demand a poll which will normally result in one vote for each share held, and the result of the poll will prevail over the show of hands. Although shares prima facie carry equality as regards return of capital on dissolution, right to dividend and voting (although of course if I own more shares than you I shall have more votes etc., for that reason) this presumption of equality can be rebutted by the articles of the particular company, which could, for example, provide that each of my shares shall carry 100 votes and each of your shares one vote. A father who wishes to retain management control of his farming company and yet give away the great bulk of his shares to his family to avoid estate duty on his death could employ this device of weighted voting, but he must not vote himself unduly large remuneration for his management services or otherwise absorb an unrealistic proportion of the company's income or he will be charged to estate duty on that ground alone.

The first directors are usually appointed by those who create the company. Later appointments are governed by the articles, which usually provide for their being appointed by the members in general meeting. It therefore follows that if I own over 50% of the shares (assuming no weighted voting) I elect or dismiss the entire board of directors and, in general meeting, prevent all resolutions being passed of which I disapprove and, conversely, pass all simple majority resolutions by my own vote! The practical distribution of the voting strength is a cogent thought to be borne in mind when deciding what influence one is likely to be able to exercise in the affairs and destiny of the company and conversely what influence is likely to be exercised against one by the various factions which may inhabit the company! Factions within the company are not infrequently locked in prolonged internecine warfare with one another.

Care should also be taken in deciding how much power should be given to the directors by the company's constitution and how much to the general meeting. The directors are entitled to exercise the powers conferred on them without any regard to the wishes of the general meeting, and the general meeting can only alter this state of affairs by altering the article ($\frac{3}{4}$ majority needed and not easy to obtain) to reduce the powers of the directors, or by dismissing the

directors by ordinary resolutions, but the directors will be entitled to damages if they hold long-term service contracts with the company which are broken by the dismissal.

Borrowing by the company.

A company frequently desires, in addition to the capital paid in by the members in return for their shares (share capital) to raise further money by borrowing (loan capital), the loan creditor(s) often obtain security by taking a mortgage upon the company's assets. It should be noticed that a company is usually in a position to offer a more extensive range of assets to secure the loan than an individual who owns the same assets. The reason of this is that whereas both may mortgage their land, an individual is unable to offer his goods (livestock, machinery etc.) as additional security for the loan without paralysing his trade, since each time he wished to sell anything he would need the consent of his mortgagee, plus various other legal complexities. But a company is permitted by law to include its goods as part of the security offered (what is known as a floating charge on the goods) and to dispose of them freely until the mortgagee becomes entitled and chooses to enforce his security. The mortgage will then attach to whatever goods happen to be owned by the company at the time when the security is enforced (usually by Alizure and sale of the goods). Inclusion of the goods as part of the security increases the value of the assets available to the lender if he has to enforce it and hence tends to induce him to lend more.

Two extra points should be borne in mind. Firstly, interest at a normal commercial rate paid on money borrowed from strangers for trading purposes is an allowable deduction when computing what profits made by the company are chargeable to tax, whereas dividends paid on the same amount of share capital subscribed by the members are not deductible when computing taxable profits. Secondly, since the company is a separate legal entity from its members, it follows that a farmer who considers his enterprise to be a risky one can form a company with limited liability and sell his business to it in exchange for shares and, mainly, a mortgage on the company's assets; when the value of the shares and the mortgage should, of course, equal the value of the business. Should the company later trade unsuccessfully and become unable to pay its debts, he, by virtue of his security, will rank ahead of at any rate most of the company's creditors in claiming such assets as the company has up to the amount of his secured debt.

Dissolution of the company

This usually takes place either
(a) by court order because the company cannot pay its debts
or (b) by resolution of the members to dissolve.

Usually a $\frac{3}{4}$ majority is required to pass the resolution. On dissolution a person will be appointed to sell the assets, pay the debts and distribute any surplus to the members in accordance with their rights.

Companies may be further classified into private companies and public companies.

Private companies have a minimum of two members and a maximum of 50 (remember for partnerships the maximum is 20). Such companies are in economic reality (but not in law) sole traders or partnerships trading with limited liability for all members (unless, of course, they elect to form an unlimited company). Being a relatively small group of persons in close personal association, they must by law prohibit any invitation to the public to subscribe either share or loan capital (i.e. the members must find the share capital by private agreement amongst themselves) and any loan capital by private arrangement between themselves or by negotiation with an individual. They must also, to prevent an outsider being brought into the group of members without the concurrence of the group expressed in some fashion, restrict in the articles of association the right of a member to transfer his shares. The law does not state what form the restriction is to take; restrictions often employed are either that no transfer of shares may be made without the consent of the directors, or that before transferring the shares to a non-member, the members must first be given a chance to buy the shares at a fair price. The form of restriction employed deserves attention, since it obviously affects the marketability, and often the value, of the shares.

Private companies will suffice as the vehicle for all but the very largest farming enterprises.

Public companies. Only those persons with grandiose schemes should indulge in creating a public company. The only likely purpose in creating such a company is to persuade the investing public at large to take up shares in the company and subscribe enough capital to enable a really large-scale enterprise to be established with the proceeds. Since so large a body of members could not exercise any detailed surveillance over the company's affairs, much power will be placed in the hands of the directors, and at least one managing director will probably be essential. The calibre of the directors will largely determine the success or otherwise of the company. At the annual general meeting the

members will, in theory at any rate, be able to hold the directors to account for their stewardship of the company during the year previous to the meeting.

The principal features which distinguish a public company from a private one are:

(1) If the public are to be invited to take up shares, clearly the existence of the proposed issue of shares must be brought to the public attention, and this can only be done by circulating a document (known as a prospectus) by newspaper advertisement, leaving quantities with bankers and stockbrokers to distribute to their customers, etc. The bankers and stockbrokers will have to be paid a small commission, known as brokerage, for this service. If the law did not step in here, the document might be couched in induly vague but glowing terms concerning the assets and prospects of the company. The law does step in, and prescribes an extensive amount of factual information concerning the company which must be included in the prospectus, and the directors and others authorising the issue of the prospectus are in general liable both criminally and in civil actions by dissatisfied shareholders for damages resulting from false or misleading statements in the prospectus.

The cost of preparing, printing, advertising and circulating the prospectus should not be under-estimated.

(2) A Stock Exchange quotation for the company's shares will usually be desirable in order to improve the marketability of the shares and so enhance the attractiveness of the issue. Before granting a quotation the Stock Exchange will investigate and want to be satisfied about the affairs of the company. It is not unknown for companies to be formed with the sole, albeit unavowed, purpose of defrauding the company's shareholders, or the company's creditors, or both.

(3) The directors must by law make an estimate of the capital sum required to carry on the company's business effectively. If the public do not collectively subscribe this sum in response to the prospectus, the attempted issue has by law failed totally and all money subscribed in response to the prospectus must be repaid to the applicants for the shares, thus all the expenses of the issue have been wasted. The directors may seek to insure against a disaster of this kind by approaching persons called underwriters and asking them to agree to take up whatever shares comprised in the issue are not taken up by the public. The directors should make sure that the underwriters have sufficient financial resources to meet their commitment. In return for this service, the underwriters will be paid a commission calculated on the value of the entire issue. The rate of commission will, of course, depend on the underwriters assessment of the likely extent to which he is on risk, but by law the maximum commission payable must not exceed 10% or the rate prescribed by the company's articles, whichever is the less. The underwriter would, of course,

decline to underwrite if he thought the likely extent of his risk was greater than his commission.

(4) A large public company is, of course, by nature a pretty impersonal thing. Any restriction imposed by the general law on the right of a member to transfer his shares freely would clearly be quite out of place here, and is only appropriate to private companies (see ante). A member of a public company has therefore an unrestricted right to transfer his shares except where this right is cut down by the articles of association of his particular company.

(5) A public company cannot begin trading until the Registrar of Companies grants it a trading certificate; compliance with various matters must be proved to the Registrar before he will grant it.

The Taxation Aspects

These can only be dealt with briefly in a paper of this nature.

(a) Estate duty. This has already been discussed, but it may be added that the company should itself occupy the farm land which it owns and not let it to someone else, otherwise a person with a controlling stake in the shares of the company, its management or its income will lose an allowance of 45% reduction in the amount of estate duty on the agricultural value of the agricultural property. No such allowance is claimable anyway by persons with lesser interests in the company when duty is levied on their shareholdings, whereas it would have been claimable by a partner with only a minor share of the partnership farm.

(b) Stamp duty (not a large sum), is attracted on a conveyance of land to the company, on a transfer of shares and on a mortgage made by the company.

(c) A company pays corporation tax on its profits. This is at a slightly higher rate than income tax, and probably likely to remain at a higher rate. If the income from the enterprise is modest, it is better to be a partnership, with each partner paying income tax on his share of income (although the Crown could in law hold any partner liable for the tax on all partnership income, leaving that partner to recover their proportion of tax from the other partners). But if the income is large enough to give rise to extensive surtax upon the partners, it is generally better to trade as a company. The erstwhile partners become directors instead and the company pays them directors fees (on which they pay tax as earned income). The fees paid to the directors are a permissible deduction in computing the company's profits liable to corporation tax. Until recently there was a legal restriction on the amount of directors' fees deductible in computing profits, but this has now been removed. However, the Inspector of Taxes may seek to challenge a

fee wholly disproportionate to the work involved as being a payment not really made for the benefit of the trade.

Whereas all partnership income is taxed as if distributed to the partners, whether or not part of it is in fact ploughed back into the development of the business, companies are to some extent privileged in this respect. A partner pays income tax and surtax. A company pays corporation tax on its profits and income tax on any dividends which it elects to distribute to members out of its taxed profits. Thus by retaining profits in the business it keeps down the amount of tax payable.

Certain companies (known as close companies),are, however, taxed as if they had distributed a dividend up to a certain level, whether they in fact do so or not, (and the individual members receiving, or deemed to receive, the dividend will be liable to surtax thereon if their income comes within the surtax range). Nevertheless such companies are only considered to have distributed at most 60% of their trading profits, and less than this if the glib tongues of the directors can persuade the Inspector of Taxes that a higher level of profit retained in the business is justifiable for its development.

The definition of close companies who are thus deemed to have distributed part of their income as dividend is extremely complex, but it is broadly true to say that only large public companies escape from the provision and all small business trading as companies and all family companies are caught by it. Even so, a heavy surtax payer is better off paying tax on some of the business profits than on all of them.

Capital gains tax. Inflation largely government promoted, will see to it that a notional and taxable gain ensues, although there will often be little or none in reality (largely of course a recurrent levy on capital). Here the position of the company is unfortunate. Whereas an individual pays capital gains tax at a maximum rate of 30% and sometimes less, a company is charged to corporation tax at 45% on its capital gains. Moreover a large capital gain by a company may well enhance the value of its shares, and when a member sells his shares he will be taxed again on the gain, so that the same element of gain is taxed twice. Capital gains tax is deferred by postponing any disposal of the asset which is going to result in a gain as long as possible (which will not be beyond one's death, since one is by statute deemed to dispose of all one's assets on one's death!

A conveyance of all or part of a farm by way of sale or gift will be a disposal of all or part of it, and so will a conveyance of the farm to a company unless the farm and all its business assets is transferred to a company in return, wholly or partly, for shares or debentures in the company. But if the

shares are then given away this will be a disposal of the shares. A transfer of land to trustees for a newly formed partnership apparently constitutes a disposal of the whole of the land even though the transferor is himself going to be one of the partners in the newly-formed partnership. One should think especially carefully before making a 'disposal' which is not in fact a sale, because this will result in a tax liability without any sale moneys out of which to pay the tax! On the other hand, the potential estate duty liability may outweigh the capital gains tax liability, so one may be driven to incur the latter to avoid the former.

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March 1970

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