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MINNESOTA FARM BUSINESS PARTNERSHIPS:
LEGAL AND ECONOMIC CONSIDERATIONS

BY

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Minnesota Farm Partnership Numbers, 1978

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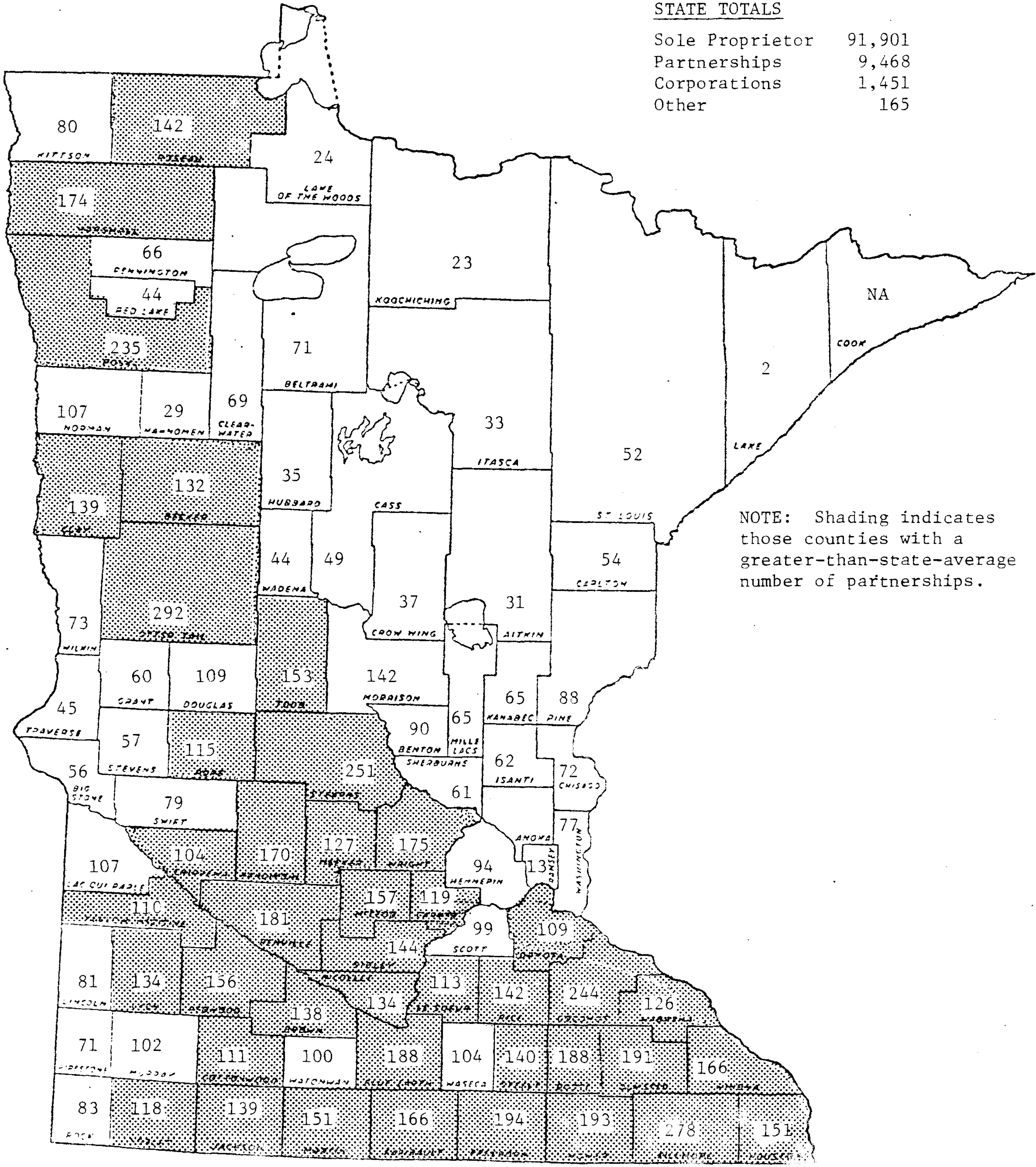

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MINNESOTA FARM BUSINESS PARTNERSHIPS: Legal and Economic Considerations

K. H. Thomas, P. Kunkel, D. C. Dahl*

A handshake and you're partners! That's about all it takes to become business partners under present law. However, it should be recognized that forming an effective, lasting farm business partnership is a complex process, one requiring that you first think through carefully what you are about to shake hands on. Likewise, what you are shaking hands on should be put in writing so that you will not have to commit such an important event to the whims of memory.

The purpose of this bulletin is to provide existing or potential farm families and those who work closely with them in such matters, with a detailed discussion of the process of establishing and operating a farm business partnership. The first part focuses on the question: should we even be considering a partnership? It discusses the various types of business arrangements available and sets out guidelines as to where they tend to fit. The second part discusses the question: can we make a partnership work from a personal, managerial, financial and total family standpoint? Part III provides a detailed discussion of the process of developing a written agreement relative to the formation, operation and dissolution of the proposed partnership arrangement.

PART I

SHOULD WE BE CONSIDERING A PARTNERSHIP?

For many farm families the first question to be answered is: should we even be considering a partnership arrangement? Often a good, hard first look at your situation will suggest that you are not ready for a partnership. Or, in some cases, the situation may call for a more complex arrangement like the corporation.

To help answer this question we shall first explore the partnership form in some depth, including a discussion of what it is and some of its advantages and disadvantages. We shall then provide a brief description of other business arrangement alternatives and close with some guidelines as to where the partnership and these other arrangements tend to best fit.

I. The Partnership: Definition, Advantages and Disadvantages, Tax Consequences

In this first section we shall take a fairly detailed look at the partnership form of business organization, focusing on the questions (1) what is it? and (2) what are some advantages and disadvantages of doing business under the partnership form?

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A. What is a Partnership?

A general partnership is an aggregation of owners. Two or more persons contribute their assets to the business, and share with each other management responsibility, profits, and losses. Each partner pledges faith in the other partners and stands liable for the actions of all partners within the scope of partnership activities. The structure and manner of operation of a partnership may vary with each business. Whatever is agreed upon by the partners forms the terms of the partnership. For example, the law provides that in absence of agreement, profits of a partnership are split equally between partners, but the partners by agreement can allocate profits in any manner they choose.

For the most part, a partnership is viewed legally as an aggregate of its members rather than a separate legal entity apart from its members, as is a corporation. A partnership can, however, act as a separate entity in a few limited situations. A partnership may do business with a distinctive firm name. It may acquire, hold and convey property in the partnership name. A partner may contract with his partnership. For tax purposes, the Internal Revenue Service merely requires that a partnership file an information return.

A partnership, being a voluntary personal relationship, may arise informally--without a written or formal agreement. However, it is customary (and better practice) to define the rights and duties of the partners in a written instrument known as a "partnership agreement". We shall examine the development of such an agreement in more detail in Part III of this bulletin.

Minnesota law provides that where the following five elements are present a partnership exists.

1. An association;
2. Of two or more persons;
3. Carrying on a business (more than a single venture);
4. As co-owners;
5. For profit.

State law also establishes rules for interpreting whether the five elements listed above have been fulfilled. The receipt by a person of a share of the profits of a business is strong evidence that he is a partner in the business and, that a partnership does exist. If, however, the profits were received in payment of a debt, wages, rent, interest or payment for the sale of property, no partnership is presumed to exist. Nor does joint ownership of property by itself establish a partnership. Whether a relationship is deemed by law to be a partnership is important because of the relative advantages and disadvantages of partnership (see parts B and C, below).

In addition to the "general partnership" discussed above, there is another type of partnership--the limited partnership. The characteristics and uses of a limited partnership will be discussed briefly in Section II of Part I.

B. Advantages of a Partnership

Flexibility in Organization and Operation. Partnerships, like sole proprietorships, are relatively simple to organize and operate. They may be formed and dissolved with few legal restrictions. Within the broad limits of the state law, the partners can agree on any partnership structure and operation without getting prior approval from any governmental agency. And once a partnership is formed, there are no boards of directors, officers or formal meetings involved. The partners may change the organization or dissolve it entirely at any time. Thus, flexibility and maximum individual freedom are preserved.

Means of Pooling Capital Resources. A partnership often provides an effective means of pooling several individuals' capital resources. As farming becomes more complex and expensive, modernization and labor-saving technology are beyond the reach of many one-man operations. However, if two or more individuals with similar objectives combine their assets, they may be able to finance a complete, modern farming enterprise. Thus, the efficiency of a farming operation may also be enhanced by forming a partnership.

Sharing of Management Responsibilities. As farming operations grow, management responsibilities become more complex. A partnership can pool management resources and possibly produce a more profitable enterprise. Partners may agree to divide management duties in any way that they desire, so long as they all consent to it and thus provide for specialization in management. For example, one partner may manage the livestock operations while another handles the cash crops. In absence of such agreement, Minnesota law provides that all partners have equal voice in management decisions regardless of their financial interest. This means that as far as the general and ordinary business of the partnership is concerned, a majority vote would control. But extraordinary matters may require a unanimous vote.

Possible Tax Advantages. A partnership pays no tax on its income although an information return is filed. Unlike the regular corporation, partnership income is taxed only once. Partnership profits are allocated to the partners and the individuals pay the tax. Whether individuals in a partnership will pay more or less tax than under a corporate structure, depends upon the level of business profits and the corporation's ability to use retained earnings effectively. Compared with a sole proprietorship, a family partnership may permit substantial tax savings. Income may be divided among more people, thus, possibly keeping the taxpayers in lower rate brackets. (For further discussion of tax consequences see Section I D.)

Facilitation of Business Transfer. A partnership may be used effectively as an estate planning tool. A father often wants to be relieved of some of the responsibilities involved in operating the farm business or may be looking forward to retirement, while his son is in need of help in getting started in business for himself. A father-son partnership may be used to achieve the goals of each partner. A son may get established by contributing labor and management services and some personal property, while a father may gain more leisure time by a carefully conceived partnership. Buy-sell arrangements may be incorporated into the partnership agreement to insure that the son receives the necessary assets to gain control of the farm operation, while equitable treatment of other heirs is provided for.

C. Disadvantages of a Partnership

Unlimited Liability. General partners are subject to unlimited personal liability to partnership claimants. There are two types of liability to which a partnership may be subject, "joint" and "general" liability. For example, if an employee employed by the partnership is injured because of a partner's negligence, in a tractor accident, and wins a million dollar lawsuit, all the partners are liable in an equal amount for any payments not covered by insurance. They are thus jointly liable for that debt. However, if one partner cannot meet his share because of lack of assets, the other partners must also pay the revenging partner's share. Thus each individual could under certain unfavorable circumstances become liable for the entire judgments against the partnership. Where such a situation may occur, the partners are deemed severally liable. Partners are both jointly and severally liable for the damages caused by any wrongful acts committed by a partner within the scope of partnership business such as the tractor accident listed above. They are also jointly liable for all other partnership obligations.

For the partner with considerable assets outside the business, a partnership may make those assets vulnerable to risks not presented by a corporation. These risks cannot be wholly eliminated by a partnership agreement. Through the use of such tools as insurance, property conveyance and profit-sharing creditor status, it is possible to limit the liability of partners to a certain extent. Suffice to say at this point that the liability aspect of the partnership form is an important area. Choose your partners carefully, and discuss this aspect thoroughly with your attorney.

Continuity of Existence. While a corporation exists until formally dissolved and may be formed for a perpetual existence, whenever any general partner ceases to be a member of the firm, there is a technical dissolution of the partnership. Dissolution occurs at the end of a specified term of the partnership's existence or upon the death, withdrawal or expulsion of any general partner. Dissolution does not necessarily terminate the business nor the partnership, however. The firm continues in existence until the winding up of its affairs is completed. And, of course, the remaining partners may agree to continue

the business after the loss of a partner. Adjustments must be made between the remaining partners and creditors, however, and when a partner dies the claims of his estate must be satisfied. However, careful planning and the use of appropriate provisions in the partnership agreement may result in the continuation of the partnership business with a minimal amount of disruption. Inclusion of such provisions in the written agreement are discussed in Part III.

Property Valuation and Transfer Difficulties. In a partnership, a partner is a co-owner of specific partnership property. In contrast, a shareholder in a corporation owns a proportionate share of the net assets of the corporation. The result of this difference is that it is usually more difficult (though the facts of each situation may vary) to determine the value of a partner's interest than it is to determine the value of corporation shares. It also makes a partner's interest in a partnership more difficult to transfer in that specific property rather than shares of stock are being transferred. Again, careful planning may minimize these problems. The partnership agreement should establish the method of valuation to be used in determining the selling price of a partner's interest. Likewise, transfers need to be well thought out and handled on a business-like basis.

Divided Management Authority. Management of the partnership business is usually implied to be shared equally by the parters. A majority of partners generally control routine affairs. Each partner usually is alotted one vote regardless of his interest in the partnership. In addition, each partner is a general agent of the partnership for partnership business and may bind the partnership by his authority to enter into contracts. This joint management is often necessary to prevent domination of the partnership by a strong partner. But in some cases, sharing management responsibilities results in divided authority and ineffective management. Personal conflicts may be difficult to resolve. The result is that in some cases a partnership is unable to act due to conflicts among the partners while in other cases a strong partner controls the business. To solve such problems, a partnership agreement should clearly address the question of management and control. This aspect will be discussed in Part III.

D. Tax Consequences of Partnership

As mentioned earlier, a partnership is, for tax purposes, simply a conduit for passing income and deductions to the partners. Their taxation will be affected by individual income items and deductions from non-partnership sources. The partnership is simply a tax reporting entity which pays no income tax. Thus partnership taxation is in essence a two-step process: First, the partnership income must be computed and second, each partner's distributive share must be determined.

In general, a partnership determines its income in the same way as an individual, with some important exceptions. The partnership return must state separately long-term capital gains and losses, short-term

capital gains and losses, gains and losses from sales or exchanges of depreciable property used in the business and held more than one year, charitable contributions, dividends qualifying for exclusion, and other less common items. The partnership is denied deductions which are personal to the partners such as the optional standard deduction, the deduction for personal exemptions and itemized non-business deductions such as medical expenses, expenses for the care of certain dependents and alimony payments.

Each partner reports in his individual return his distributive share of each of the categories of partnership income, gain, loss, deduction and credit, just as if each item had been directly realized or incurred by him. Thus the character of each item is presented as it is passed through the partnership to the partner. For example, a partner offsets his gain from a sale of depreciable property used in a non-partnership trade or business with his share of the loss incurred on the sale of similar partnership property.

Each partner must include partnership deductions and credits with his own. Any limitations, such as the maximum charitable deduction, must be applied to the total. After all items of income, gain, deduction, loss or credit have been itemized, whatever remains is the ordinary income of the partnership. Each partner includes in his individual return his distributive share of the partnership income or loss (see page 35).

There is also a limitation imposed on loss deductions. The maximum loss deduction allowed a partner is the amount of his basis (investment) for his partnership interest as of the end of the year. Any excess over the basis is disallowed as a deduction for that year unless the partner increases the basis for his partnership interest by a contribution to the partnership before the end of the year.

It is necessary to maintain individual partner's capital accounts in the partnership. These accounts are necessary to determine gain or loss upon the sale of a partner's interest in the partnership and to establish the limitation on the loss deduction allowed a partner. When a partner participates in the formation of a partnership, his original basis is the amount of money contributed to the partnership plus the adjusted basis of the non-monetary property which he contributes to the partnership. This rule also applies to a partner who is later admitted to a partnership and who contributes to the partnership.

A partner's basis may increase by the following transactions which have the effect of increasing his capital interest in the partnership: (a) additional contributions to capital;(see page 34, Part III) (b) the assumption of partnership liabilities by a partner, and a pro rata share of liabilities incurred by the partnership; (see page 27, Part III) (c) a partner's distributive share of partnership taxable income; (see page 35, Part III) and (d) partnership receipts exempt from tax. Adjustments downward, but not below zero, in the basis of a partner's interest in the partnership, all of which have the effect of reducing

his investment, are required for the following: (a) distributions of partnership property; (see page 26) (b) assumption by the partnership of a partner's personal liabilities, and decreases in the partner's share of partnership liabilities; (see page 34) (c) the partner's share of partnership losses; (see page 19) and (d) the partner's share of non-deductible expenditures of the partnership which are not properly chargeable to the partner's capital account.

If a partner engages in a transaction with the partnership other than in his capacity as a partner, the transaction is treated as one between the partnership and a non-partner. Thus a partner may sell property to his partnership and treat the gain or loss as his own. Such transactions are carefully examined, however, and there are two limitations designed to prevent realization of losses on sales between a partner and his controlled partnership and to prevent sales as a gain to obtain a stepped-up basis for depreciation purposes. The first limitation disallows losses on sales of property between a partnership and a partner owning more than a fifty percent capital or profit interest in the partnership. The second limitation denies capital gains on a sale between a partner and his controlled partnership of any asset which in the hands of the transferee is not a capital asset. Assets which will produce ordinary income include inventory, stock in trade, and depreciable property used in the trade or business. For purposes of these limitations, in determining whether a partner has control of the partnership, a person will have attributed to him the capital or profit's interest owned by the members of his family and by any trust, estate, corporation or partnership of which he is a beneficiary, shareholder or partner to the extent of his proportionate interest.

Thus, there may be some tax advantage because of division of income (see page 33) that may be counterweighted by more extensive bookkeeping required for a partnership rather than a sole proporietorship. Not only must the income and expenses be carefully documented in a partnership but separate books must be kept for contributions or withdrawals of capital. Moreover, accurate bookkeeping is doubly important in a partnership, since it is needed for tax purposes and for a fair and proper division of losses and expenses which is essential for a successful working relationship between partners. On a more positive note, however, the bookkeeping involved in a partnership might be no more extensive than a creditor might demand, if the creditor, rather than the partnership, were doing the financing of a fledgling farm operation.

II. A Brief Description of Other Business Arrangements

A general partnership is only one of several types of business arrangements that might be used. These include: sole proprietorships, modified sole proprietorships, joint ventures, limited partnerships and the corporation. We shall now provide a brief description of these other business forms. Table 1 also contrasts the partnership with the sole proprietorship and corporation as to their business development and growth as well as retirement and transfer characteristics.

A. Sole Proprietorships

The sole proprietorship is the oldest, simplest and most prevalent form of business enterprise. If a sole proprietor needs help, he may hire others. If he needs more capital than he owns, he may borrow from others. If he needs more real or tangible personal property, he may rent from others. If the business loses money, he must bear the losses alone. If there are profits, he need not share them. He bears unlimited personal liability for the contracts he enters and the wrongful acts committed by himself or his employees within the scope of their employment.

There are no formalities involved in the organization of a sole proprietorship and no expenses beyond the capital needs of the enterprise need be incurred. The obtaining of credit by the sole proprietor is limited by his solvency. On the other hand, he is not bothered by problems of management and control.

There is generally no continuity of existence with a sole proprietorship because on the death of the proprietor, his proprietorship obviously ends. When it comes to tax considerations, the sole proprietory is like any other person and is treated accordingly. His business income and other income are treated together.

In short, the simplicity, informality and low cost of the sole proprietorship make it especially suitable to small, one-man enterprises. Thus, if after your analysis, you find that continuing to operate alone is the best route, you will be in good company, for about 85 percent of our farm businesses are operated as sole proprietorships.

However, if you do find that you want to operate jointly but feel that you are not suited to a partnership, then some form of "modified" sole proprietorship or joint venture arrangement might be considered. These arrangements can be grouped into two broad categories. The first category includes various types of employer-employee arrangements, such as wage agreements, wage incentive plans and wage and income share arrangements. The second category would be one in which the junior partner contributes at least some personal property as well as labor and management to the business.

B. The Limited Partnership

The limited partnership is a special variation of the partnership form. It is most commonly thought of as a business that involves "silent" partners. The limited partnership is really a hybrid form of business organization. It possesses selected features of the partnership and certain attributes of the corporation.

Like the general partnership, the limited partnership has partners. But these partners are divided into two groups: the general partner(s)

and the limited partners. The general partner(s) has rights and obligations similar to those when operating as a general partnership. He usually contributes capital, has unlimited liability for the contractual, associational and tortious acts of the business, and is solely responsible for managing the limited partnership. He is limited in sharing profits or losses by the limited partnership agreement which assigns financial results to both general and limited partners in accordance with their contributions.

The limited partners usually contribute capital to the business, and share in the profits or losses of the business. However, they cannot share in management decision-making. The losses for which they are liable and responsible for are limited to the value of their contribution.

The limited partnership has been used in two major ways in farming: (1) to serve as a "tax shelter" for wealthy nonfarm investors and (2) to aid in farm business expansion and permit nonfarm investors to realize gains in farm real estate appreciation. However, farm families should be familiar with it in that it may provide a means of keeping off-farm heirs interest in maintaining their assets in the business. It may also be useful to the senior partner who may choose to go this route rather than use a rental arrangement upon retirement.

C. The Corporation

A corporation is a separate legal entity created under state law. The owners of a corporation are called "shareholders" because they own shares or interests in the corporation. A corporation is subject to greater governmental regulation and control than other forms of business in its formation, operation and dissolution. Minnesota law generally restricts corporate farming to two types of corporations, "family farm corporations" and "authorized farm corporations". A family farm corporation is one that is formed for the purpose of farming in which a majority of the voting stock is held by, and a majority of the shareholders are, close relatives. In addition, at least one of the related persons must reside on, or actively operate, the farm. An authorized farm corporation is made up of fewer than five shareholders with only one class of stock. A majority of its shareholders must reside on the farm or be actively engaged in farming.

Formation of a corporation involves greater expense and formality than either a partnership or a proprietorship. Typical are organization taxes, filing fees, drafting of articles of incorporation and bylaws, and the keeping of minutes of formal meetings. Likewise, operation of a corporation is more formal. Annual meetings and reports are required by law.

A corporation is managed by its board of directors, which is elected by the shareholders. This separation of ownership from management is characteristic of the corporate form. While the shareholders in a small, closely held corporation are often also the directors, the

individual wears two hats. When he acts for the corporation he is technically acting as an officer, not as an owner. Thus, the separation of ownership and management always exists legally.

The liability of the shareholders is usually limited to their respective capital contributions. However, if corporate formalities are not observed, the corporate form may sometimes be disregarded. The interests of shareholders in a corporation are usually evidenced by share certificates. Usually, these are freely transferable. But only to the extent that the corporation would still qualify under Minnesota restrictions of corporate farming. This free transferability facilitates family and estate planning.

The corporation is the only form of business enterprise which theoretically may have perpetual existence. While the duration of a corporation may be limited, most are formed for perpetual duration. This avoids a premature termination when a major shareholder withdraws from the business, retires or dies.

The corporation is regarded as a separate taxable entity for most federal and state tax purposes. This accounts for the most significant tax advantages and disadvantages of the corporation. On the plus side, the corporation provides an opportunity to spread taxable income over one more taxing unit. This, combined with favorable tax rates and opportunities for deductions puts a corporation that can use its retained earnings effectively in a favored tax position. On the minus side the corporation is subject to double taxation in that it is subject to payment by the corporation of tax on its income at the corporate rates, and by the shareholder on the dividends received at the individual rate applicable to him on the basis of his total income. Substantial relief against double taxation is provided by Subchapter S of the Internal Revenue Code. Under Subchapter S a "small business corporation" may elect not to be taxed at the corporate level, but to have its income, whether distributed or not, passed through and taxed pro-rata to its shareholders. Corporations making such an election are known as "Subchapter S corporations" or "tax-option corporations."

Usually there is little advantage in incorporating the typical-sized farm business. However, the corporate structure will likely fit well where:

1. Two generations and/or considerable assets are involved--where transferability, continuity and/or management control of the business are key issues.

2. The parties involved are paying taxes on income over $40,000--fringe benefit and tax rates favor incorporation.

3. The business is large enough to gain special liability concessions from creditors and/or one or more of the partners have other business interests which they wish to protect, liability-wise.

Table 1 -- Comparison of farm business organization alternatives*

	Sole proprietor	Partnership	Corporation
Nature of entity	Single individual	Aggregate of two or more individuals	Legal person separate from shareholder-owners
Business development and growth considerations			
Source of capital	Personal investment, loans	Partners' contributions, loans	Contributions of shareholders for stock, sale of stock, bonds and other loans
Liability	Personally liable	Each partner liable for all partnership obligations	Shareholders not liable for corporate obligations
Limits on business activity	Proprietor's discretion	Partnership agreement	Articles of incorporation and state corporation law
Management decisions	Proprietor	Agreement of partners	Shareholders elect directors who manage business through officers elected by directors
Income taxes	Income taxed to individual 50% deduction for long-term capital gains	Partnership files an information return but pays no tax. Each partner reports share of income or loss, capital gains, and losses as an individual.	Regular corporation -- Corporation files a tax return and pays tax on income; salaries to shareholder-employees deductible. Capital gains offset by capital losses. Shareholders taxed on dividends paid. Tax-option corporation -- Corporation files an information return but pays no tax. Each shareholder reports share of income, operating loss, and long-term capital gain
Retirement and transfer considerations			
Life business	Terminates on death	Agreed term, terminates at death of partner	[illegible]
Effect of death	Liquidation	Liquidation or sale to surviving partners	No effect on corporation. Stock passes by will or inheritance
Transfer of interest	Terminates proprietorship	Dissolves partnership, new partnership may be formed if all agree	Transfer of stock does not affect continuity of business -- may be transferred to outsiders if no restrictions

*Adapted from North Central Regional Extension Publication No. 11 The Farm Corporation, revised 1974

III. Should We be Considering a Partnership? - Some Guidelines

Which business arrangement would be best for you will depend upon your present situation and your objectives. Figure 1 characterizes the major situations that a farm family might find themselves in. It also indicates the kinds of business arrangements that tend to fit each of these situations.

A. The Testing Period

If the potential partners have not operated together for any extended period of time, then they are not likely to be ready for a partnership. The son may not be completely certain he wants to farm. In this situation the potential partners should go through a "testing stage" to determine whether the parties involved really want to farm and whether they can get along on a personal and business basis.

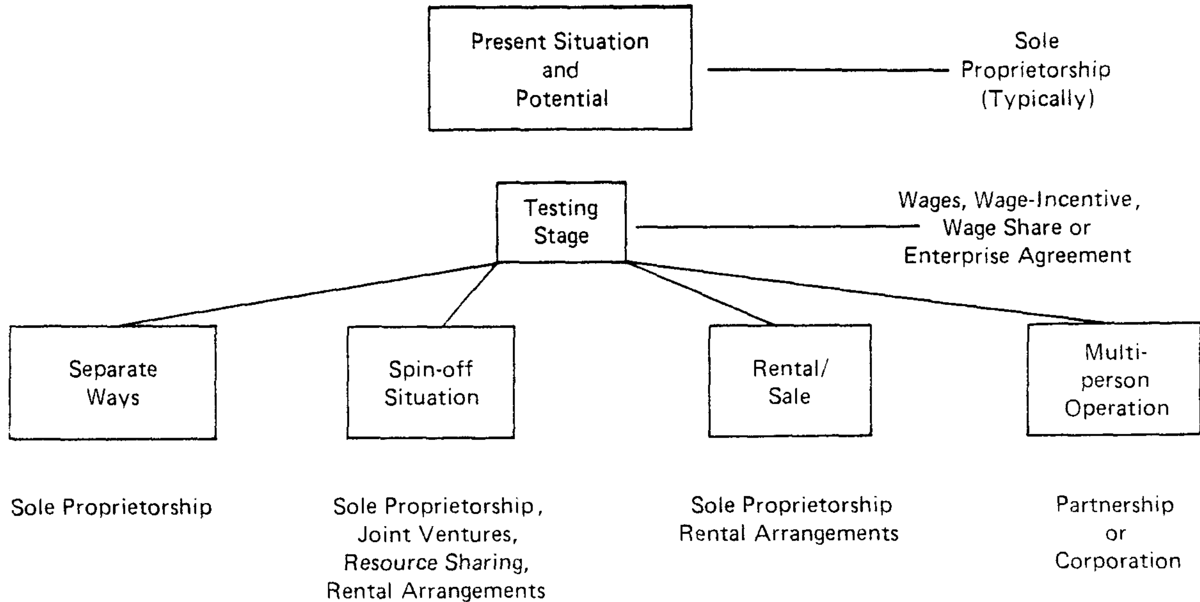


Figure 1. Alternative Business Arrangements and the Decision Framework

Business arrangements adapted to the testing stage can be grouped into two broad categories. The first category includes various types of wage, wage-incentive, and wage share arrangements in which the son contributes primarily labor and possibly some management. The second category includes various joint working agreements that may at times border on being a partnership. With these latter arrangements, the son will be supplying at least some personal property as well as labor and management.

1. Employer-Employee Type Arrangements

First, alternative arrangements in which the son contributes primarily labor and some management are discussed.

a. Wage agreement

Many families find the easiest way to start a son in the business is to pay him wages. This plan may also include a year-end bonus and benefits. This is probably a good place to start the testing process. However, two notes of caution are in order. First, the wage should

interest in the success of the business, he will lose interest in farming if he is forced to work on a wage basis for an extended period of time. One approach is to pay the son well in excess of a hired man's wage. This would keep the son motivated, test the financial adequacy of the business and insure that dad will not prolong the arrangement unduly.

b. Wage incentive plans

Wage incentive plans often are used to encourage a farming son to take a more active interest, and additional responsibility, in the farm business. For the employee, the compensation should be in addition to his basic wage, not a substitute for a reasonable wage, agreeable working conditions, and adequate housing. It is assumed that the result of an incentive plan will be increased returns to the father as well as the son. In a sound incentive program, the workers should be able to influence the size of payment he receives by the work he performs. The payments should be sufficiently large and attainable to encourage extra effort. A written agreement should be developed describing the purpose of the arrangement, employee responsibilities, method of calculating and making the payment, and provisions for arbitration.

c. Wage and income share plans

A wage and income-sharing plan is particularly well-adapted as a beginning agreement when the son is not sure of continuing in business on the home farm, or when he does not want to become too involved financially. From a legal standpoint, a wage and income sharing, but not loss-sharing, plan establishes an employer-employee relationship rather than a partnership. The employee and employer, thus, would avoid some of the liability aspects associated with the general partnership.

Under this plan the father typically furnishes the farm, the housing for the son, all of the farm personal property, and his own labor and management. He also pays all farm expenses. The son works on the farm full-time and receives a guaranteed monthly wage and a share of net farm income. The wage rates could be comparable to current wages for similar services by hired help in the area.

Some of the advantages of wage-based types of business organizations include: (1) determining if the son really wants to farm and if the father and son can get along well when farming together; (2) giving the son experience and "know-how" about farming; and (3) starting and stopping easily as there is no jointly held property, etc. Among the disadvantages are: (1) the son's major interest in the farm may be his monthly paycheck; (2) payment in wages does not encourage savings nor does the arrangement permit the son to gain an equity in the business; and (3) such plans are often kept in force long after the son is ready to become a full-fledged member of the business.

2. Joint Working Agreements

The testing period may extend long enough or relationships develop fast enough that the son begins to contribute personal property to the farm business along with his labor and management. For example, a so-called holding pattern may be in order in those cases where the father is very close to retirement. Rather than expanding the business, establishing a partnership, etc., the parties may decide to extend the testing stage and become involved in some type of joint working agreement. Two types of joint working agreements will be explored at this point, though there obviously could be many others.

a. The enterprise-type joint working agreement

In this arrangement the farming son may furnish some personal property (e.g. livestock and machinery) and some management in addition to his labor. He normally would not make whole farm decisions, but may make most of the major decisions for one enterprise.

The son may buy into a given enterprise such as the dairy herd, cow herd, or hog enterprise on a partial or complete basis. He may either pay the father for the use of feed, buildings, and pasture, or work out a livestock lease arrangement whereby part of the production is given to the father. Any resultant agreement should be put in writing and cover such topics as job responsibilities, contributions, distribution of income, method of settling disputes, and dissolution.

Enterprise working agreements should be normally regarded as only temporary. Most farms are too small to be subdivided into separate enterprises. There is a tendency for the son to concentrate on his enterprise at the expense of the overall farming operation with this type of an arrangement. In addition, the son is exposed to considerable risk when he depends on one source of income. Record keeping may be difficult.

b. Joint venture-type working agreements

There may be situations in which the father and son operate in a joint venture agreement and share labor and machinery but own or rent their own land, livestock, etc. Normally, the family should have made some long range decisions before entering such agreements and thus would have moved out of the so-called testing stage into the spin-off stage, etc.

The length of the testing period depends on the family situation, objectives and progress toward deciding which future route to follow. Two to three years normally should suffice for the testing period. Delaying a decision beyond this time should be viewed critically, particulary if the parties are still involved in a wage-type arrangement. Remember, the purpose of the testing period is to determine whether the son wants to farm and whether the parties can work together. Once these issues have been resolved, they should be prepared to move out of the testing stage.

B. Farming Separately or Together - Some Possible Routes and Arrangements

This section discusses some possible routes and types of business arrangements that might be considered after the testing stage.

1. Going Your Separate Ways

The decision may be made to dismantle any joint arrangements that may have developed during the testing stage and to go your separate ways. Such a separation may be caused by an inability to work together or the father's unwillingness to transfer any property. Or, it may have been part of the plan all along because the original business was too small.

Full and frank communications are important if such a separation is likely to occur. It is unfortunate when parents have assumed that the son would eventually farm on his own, but the son was under the impression that he would operate the home farm. The sooner both parties can agree on their future course, the better.

If it appears that a split is to occur, care should be taken to insure that good records are kept of how much each party has contributed and who owns what property. An answer eventually must be given to the question: do you wish to keep the home farm in the family in the future? If the answer is no, then the decision becomes a parental one of whether the farm is to be disposed of before or after death and how. If the farm is to be kept in the family, more complex decisions must be made as to who will eventually own it, how it will be operated, etc.

2. Spin-Off Situation

In cases where the home farm is too small or differences surface between the father and son as to how the business should be developed, a spin-off situation might prove desirable. The son might rent or buy a separate farming unit. Machinery might be owned jointly, or owned separately and used jointly. They normally would exchange work, and possibly operate a livestock operation together. Such joint working arrangements can take on many forms and can get a son established in farming without jeopardizing the security the father has built up in his own business. It also permits the son to better exhibit his management know-how and establish his independence because he has a separate business entity. The key to this arrangement is the son's ability to obtain a farming unit sizeable enough to generate enough profits for an adequate standard of living and net worth improvement and which has future business growth potential.

3. Rental/Sales of Home Farm from Father to Son

The father may be at that stage in his career when he is ready to rent the farm to the son. The father usually wholly or partially retires from the day-to-day work and management of the farm. If there is adequate

housing, the father and mother often continue to live on the home farm and receive part of their living, especially food and housing, from it.

Whether the rental arrangement should be a cash or share lease depends on the financial circumstances of the father and son. A cash lease shifts the risk of low prices and yields over to the son. He has to pay the father a fixed rent regardless of price and crop conditions. A flexible cash lease could be developed to minimize some of the risk assumed by the son. With a share lease, the father shares at least part of the financial ups and downs of the farm business.

It usually is recommended that, at the beginning of the rental period, the son acquire full ownership of livestock, feed, crops and supplies. The father will be relieved of the worry of managing these assets, and the son will be in a much better financial and managerial position to take the final step towards attaining ownership of the home farm. Ownership of the machinery sould be worked out with your accountant to avoid investment credit recapture.

The rental arrangement is a fairly satisfactory agreement when the father wants to retire but needs a source of retirement income. The son may find it to his advantage to rent rather than buy at this time. However, it is necessary that the father and son decide on some type of arrangement to eventually transfer at least partial ownership as the son's future in farming may be closely tied to acquiring control of the real estate and other business assets.

4. Multi-Man Operation

When the parties involved can get along well together and the existing farm business is adequate in size or can be expanded without jeopardizing the parents' financial position, then farming together in a formal multi-man operation seems in order. This usually involves the use of a partnership or corporate-type of business arrangement. Where these arrangements best fit was discussed earlier in Section II.

The remainder of this pamphlet should acquaint you with some of the considerations which go into deciding on a partnership and which go into determining how such a partnership may be structured.

PART II

CAN WE MAKE A PARTNERSHIP WORK?

Operating successfully over time under any type of joint operation such as a partnership is a difficult task. As one experienced farm management agent said recently, "If there is any other way you can operate a farm business, do it."

But still many families wish to give serious consideration to the possibility of operating under a partnership. Because of the high

potential for difficulties to arise it is important that you evaluate your situation carefully asking the question: Can we make a partnership work?

Every business endeavor needs certain characteristics for success. This is especially ture for a farm partnership since personal as well as business considerations are involved. The following discussion presents some important considerations and procedures for evaluating your chances of making a partnership work.

I. Can We Make a Partnership Work--Personally?

Before becoming part of a partnership you should make a careful evaluation of the human relationships that exist or might develop between partners as well as between partners and other family members.

A. Relationships Between Partners

The same kind of analytical reasoning used in buying a farm or major piece of equipment should go into selecting your partner. Many times sons inherit characteristics from their fathers which make them too much alike to be good partners. Often good partners are people who compliment each other rather than who are too much alike. A mutual respcet must be present between successful partners. It is important, therefore, that partners relate well to each other, both in a personal and business sense.

From a personal relationship standpoint, all parties need to be tolerant and understanding and have the ability to overlook each others' faults. More partnerships break up because of disagreements over trivial things than over major issues. No type of business arrangement will work if the partners and families are not able to work together in a spirit of harmony and cooperation. The partners must also have the ability to compromise. Senior partners often are conservative, having spent many years putting the business together. Junior partners tend to be venturesome, particularly when operating on someone else's capital. Finally, the wives must be kept informed and be interested in the business. Problems can arise with regard to housing, spendable income, labor commitments and respective partners' life styles. Therefore, they should be involved in discussions relating to these issues. The written agreement should indicate how these issues have been resolved.

From a business relationship standpoint, all parties should be working toward similar objectives to make the business succeed. It is important that all potential partners eveluate their own goals and communicate these to the other partner. Parents should be especially careful to outline their expectations of participation by other members of the family. Where goals and values differ, care must be taken to arrive at a reasonable compromise. Joint participation in managerial decisions is another "must" if a partnership is to succeed. The junior partner needs to be given an increasingly important role in management.

This growth will not occur if the senior partner always "pulls rank" or persists in saying "I" rather than "we". When partners' capabilities compliment each other, take advantage of the situation. It should also be conceded that each partner will make some mistakes.

Of course, the best way to test these personal and business relationships is through actual business operation together--thus, the need for a testing stage as discussed above.

B. Relationships Between Partners and Other Family Members

Usually a major concern of the junior partner is how he can eventually get into a position to manage and financially control the business. The magnitude of this problem will vary with the nature and size of business, the number of heirs involved and the number of years before the senior partner's retirement. Getting the junior partner into a position to invest and gain equity (through earnings and favorable treatment in the transfer of assets) at as rapid a rate as possible is important. Because of the possibility of an untimely death situation, favorable options to buy and fund buy-sell agreements need to be incorporated into the written agreement.

However, it should be recalled that another prime objective of the family should be the maintenance of overall family goodwill. Thus, plans should also provide for the fair and equitable treatment of other heirs and the financial security of the senior partner's spouse. Agreements that unduly favor the farming son should be avoided. This may mean that he will have to lose control of part of the business for a period of time or necessitate a rebuilding of part of the business. Such a happening should be viewed with favor relative to the potential loss of family goodwill which may never be recovered. Good communications among all family members is essential, particularly when arrangements are being changed or concessions made.

II. Can We Make a Partnership Work - Financially?

No matter how well partners can get along personally or how legally sound the final written agreement is, the partnership will not likely succeed if business earnings are inadequate or they are not shared in a manner that seems fair to all the parties involved. Therefore, it is important that the financial feasibility of the proposed plan be tested before the parties begin to develop a detailed written agreement. Worksheets 223 and 224 A and B are designed to aid you in analyzing your situation.[1/]

1/ Copies of these worksheets can be secured from your County Extension Office or from Extension Farm Management, Classroom Office Building, St. Paul, MN 55108

The analysis will focus on three inter-related decisions: (1) Is the business profitable enough? (2) What type of arrangements should be used? and (3) Will the plan work financially for each of the parties involved. Instructions for making the analysis are contained on the cover of worksheet 224, and will be reviewed briefly below.

A. Will the Business Generate Enough Income?

Space is provided on page 2 of Worksheet 224 for projecting the expected income from the current business. If the business is not profitable enough, space is provided on page 6 for analyzing an alternative plan.

B. Selecting and Developing the Type of Share Arrangement to be Used

Partners can set up any kind of share arrangement that they can agree to. However, the two most common arrangements to be considered are: (1) The proportional sharing approach and (2) the equal share or 50/50 approach.

1. The Proportional Sharing or Fixed Contribution Approach

With the proportional sharing approach the parties involved determine the annual use value of their respective contributions of real estate, personal property, and labor and management. Returns over operating expenses are then shared in the same proportions as the partner's respective contributions of the above fixed resources. For example, in the early stages of a typical father-son situation this split may work out to be 80/20 (80 percent for dad and 20 percent for the son) or some other proportion, depending upon the amount of resources contributed by each and the respective values and charges placed on these contributions.

In the farm family setting, the proportional sharing approach is well suited to what might be termed transitional situations. For example, it can be used effectively as a "next step" for the junior partner who has been working on a wage-share basis. He can begin to contribute some personal property without getting too financially involved or without dad feeling he is giving up too much control of the business too soon. Since profits and losses are shared on a proportional rather than a 50/50 basis, this approach also tends to limit the risk exposure of the junior partner to a greater extent than the 50/50. Therefore, in relatively risky situations it may be favored, even though the junior partner is quite heavily involved in the ownership of personal property. It may also be favored where dad has a heavy debt load and needs a larger share of excess profits than the 50/50 approach would provide. This approach may also prove useful in situations where dad is beginning to pull out of the business, causing a reduction in his labor and management contributions. Sharing profits and losses according to contributions also makes this approach particularly well suited to situations involving unrelated partners or partners of similar ages but who are making unequal contributions.

2. Equal Sharing or 50/50 Approach

This approach can best be defined as the way in which residual earnings are to be shared after paying operating expenses and for the use of certain fixed resources such as land, machinery, and labor. The important thing to recognize is that the partners do not necessarily, in fact seldom, own assets on a 50/50 basis. All that is shared on a 50/50 basis is the profit of the partnership after the partnership has paid rent to his senior partner for his excess contributions of land and machinery or other personal property. The degree of involvement of the junior partner will of course depend upon his financial situation and the income tax implications of any intra-family transfer of property, such as machinery.

In the farm family setting, it is recommended that the 50/50 approach be used in those situations where the management team has been <u>stabilized</u>. That is, the junior partner has settled down and is ready to become a stable member of the business and the senior partner is ready to begin shifting control of the business. It is usually considered to be the optimum arrangement in that it tends to foster equality in decision-making and at the same time, gives the junior partner more personal and social status. And since he is sharing 50/50 in excess profits, the junior partner can make more rapid financial progress if the business is profitable and not too risky. It is also simpler from an accounting standpoint since inventories of grain and livestock normally would be owned 50/50.

Generally, the selection of which share arrangement should be utilized can be made by comparing the characteristics of the arrangements as described above with the personal, managerial, and financial situation at hand. Both the proportional sharing and the equal sharing or 50/50 approaches can be set up in so many ways that any further fine tuning can generally be made within the approach selected.

3. Developing the Desired Share Arrangement Plan

There are three basic steps involved in developing the desired partnership share plan: (1) take an inventory of assets presently owned by each partner; (2) develop a proposed share plan paid; and (3) if necessary, consider alternative plans.

<u>Step #1 - Inventory assets presently owned by each partner</u>.

Using worksheet FM-223, take an inventory of the assets presently owned by each partner (the shaded column, page 58). Such an inventory should be complete and reasonably valued as it will be useful in determining the share of earnings to be received by each partner and in dealing with creditors and other family members. It also represents a benchmark should property be transferred and for settlement purposes upon the eventual dissolution of the partnership.

Starting with item I, cash contributed to the business should include only that supplied out of the partners' equity, not borrowed funds. Feed and supplies and market livestock inventories should be valued on a current market basis, less marketing charges. Relatively conservative and consistent market valuations should be placed on breeding livestock, machinery and real estate. Usually, partners can agree on these values. However, to avoid disagreements and possible future problems with relatives or creditors, securing an outside appraisal is often desirable. Usually there are people locally who will value your livestock; with machinery, consider the local implement dealer; and with real estate, a professional appraiser or an appraiser for credit agencies dealing in real estate financing. Once you have determined the per acre value of land and buildings for each parcel owned by the partners, calculate the rental value per acre. Under today's conditions this usually amounts to 4 to 5 percent of the market value of land. From this must be subtracted taxes, insurance and repairs to determine the net rental value of each parcel. In the case of machinery, you should indicate the year of purchase and the amount of investment credit taken. This will be useful when deciding which machines might be transferred among the partners.

Steps #2 and #3 - Develop a share arrangement plan/consider alternative arrangements.

Space is provided on pages 3 and 4 of FM-224 for developing alternative share arrangement plans for your situations. Instructions for doing these are contained on the worksheet.

C. Can the Individual Partners meet their Financial Commitments?

The remaining question to be answered is whether the individual partners can meet their financial commitments under the share arrangement selected. Space is provided on page 5 of FM-224 for making such a determination.

After completing Form FM-224 and determining the financial potential of your proposed arrangement and also evaluating the human aspect of the situation, as suggested above, you should now have made your decision as to whether you want to enter a partnership or not. If so, it is important that a written agreement be developed and communicated to all partners and affected parties. Part III of this bulletin discusses the development of a partnership written agreement.

PART III

DEVELOPING THE WRITTEN AGREEMENT

I. Introduction

Partnerships may be created by either an oral or written agreement. And, in some cases, a partnership may be implied if the business is being carried on as a partnership. (See also Part I, p. 2 to determine where a partnership may be implied.) Although partnerships may be successfully operated without a written agreement, it is strongly advised that the agreement be in writing.

A written partnership agreement can serve several important functions. First, it helps eliminate many potential misunderstandings as to what is being agreed upon. Through the drafting process, partners may come to better understand one another's positions. The written agreement thus fosters preciseness and clarity. Second, the written agreement is a ready source of reference to the partners. It provides a blueprint for the organization and operation of the business. It will be particularly helpful when disagreements arise. Third, writing and signing a partnership agreement contributes necessary formality and stability. It tends to offset the more informal atmosphere surrounding the typical family farm partnership and to create a more businesslike attitude toward the new business arrangement. Finally, there is no assurance that a partner will always be present. The withdrawal of a partner for any reason calls for the dissolution of the arrangement. Having a clearly stated procedure for handling affairs at the time of dissolution is becoming one of the most important reasons for having a written agreement.

The partnership agreement should serve as the blueprint for the organization, operation, and dissolution of the business. It should be specific enough so each partner knows his rights and obligations, but not so detailed that a business decision cannot be made without reference to the agreement. As conditions change, the agreement should be rewritten or amended to reflect those changes. The agreement should be simple in form and understood by the parties involved. But, it must be legally sound and prepared with a good working knowledge of the tax laws. To insure that the agreement is complete, it is advisable to have an attorney prepare the document. But a professional cannot decide what the terms of the agreement should be. Only the parties involved can do that. Following are some of the issues and alternatives for a partnership agreement. For your convenience a copy is attached, Appendix A - The Farm Partnership Agreement Worksheet, (FM 225) parallels the considerations set forth in the remainder of Part III and should assist both you and your attorney in formulating the actual terms of the agreement.

II. Preliminary Statements

Partnership agreements often begin with preliminary statements that set the stage for later substantive provisions defining the rights and duties of the partners. The preliminary statements identify the document as a partnership agreement, introduce the partners and their addresses,

establish the name and place of business of the partnership, present the general purpose of the business and indicate the beginning and ending dates of the partnership.

A. Introduction

Although not legally required, an introduction should be included in a partnership agreement. It sets out essential facts of the transaction including the identity of the partners, their names and addresses, and the date of the agreement.

"This general farm partnership agreement is entered into this __________________ day of _______________, 19____, by and between

Name ___________________________ Address ___________________________ and

Name ___________________________ Address ___________________________ and

Name ___________________________ Address ___________________________

A statement noting that the partners wish to form a partnership is in order as well.

B. Name and Place of Business

A partnership may exist without a name. On the other hand, choosing a name presents few difficulties. If an assumed name is to be used, a certificate setting forth the name of the business and the names and addresses of the persons operating the business must be filed with the Clerk of Court in the county in which the business is to be operated.

Designating the place of business is not a legal requirement as is the case with the formation of a corporation. However, the place of business is usually specified in a clause like the following: "The principal place of business shall be ____________________ County, Minnesota, and at such other places within or without the State of Minnesota as may be agreed upon by the partners." The legal address of the partnership should be noted.

C. Purpose of Business

A partnership may be formed for any lawful purpose, but the business in which a particular partnership engages must be sufficiently described and restricted so that no partner will be involved in a type of business foreign to his wishes. The purpose section usually states the nature of the business in general terms, though, so that the partners may have considerable freedom in making subsequent changes in operations without changing the partnership agreement: "This partnership shall engage in

a general farming business including the growing, purchasing and marketing of crops, livestock, and other farm products, and in such other business as shall be agreed upon by the partners." If the partners intend to limit partnership activities to one or more specific enterprises, a more restricted statement may be used.

D. Duration of Partnership

The date on which the partnership is created is usually easy to determine. The duration of the partnership term is not so easily agreed upon. From a business accounting and tax viewpoint, major changes in the agreement should be made at the end of the business year. The agreement can be for one year or longer periods, but a one year period provides more flexibility for changes than one for a longer period. On the other hand, it may be desirable to provide for a longer term, say 3 to 5 years, in order to provide stability when the partnership is just getting established. The procedure for serving notice regarding the termination of the agreement should be noted. In absence of a specified duration, or if the partners continue to operate after the expiration of the agreement, the agreement may run indefinitely, but may be terminated by any partner at any time without notice.

III. Initial Capital Contributions, Additions, Withdrawals

A. Initial Capital Contributions

The capital assets required to begin the operation of the farm business are usually obtained by the partnership through contributions by the partners. Partners' capital contributions may consist of cash, personal property, and real property. Contribution may be in the form of an outright transfer of property to the partnership, contributions by use only of property, and rental of property to the partnership. The tax consequences of contributing appreciated or depreciated property outright to the partnership should be considered.

1. Cash - In some businesses, cash forms the major portion of initial contributions. In agricultural businesses, however, cash contributions usually play a relatively minor part since the partnership is usually the successor to an existing business. When cash is contributed it can be either an outright transfer to the partnership or as a loan. If a loan is involved, the partnership usually pays interest on it and repays the principal over a stated period of time. If a loan is not involved, then an interest charge for the use of the cash would be in order.

Rather than contribute property outright to the partnership, a partner may wish to contribute cash which the partnership will use to purchase the property from him. However, if this is done, the selling partner must report the transaction as a sale for income tax purposes and pay the capital gain or ordinary income tax due on the transaction. The advantage to the partnership may be simple accounting and a higher cost basis for the property.

2. <u>Personal Property</u> - Personal property, consisting of feed, crops and supplies, livestock, machinery and equipment, constitutes an important part of the capital controlled by a farm business. When personal property is contributed outright to the partnership, values are placed upon the property to determine each partner's contribution. And outright contribution to the partnership transfers ownership of the contributed property to the partnership. The contributing partner loses all personal rights in the item contributed. The agreement should state how the contributing partners are to be reimbursed--whether in cash or via a loan.

One consequence of outright contribution of property to the partnership is that such property in the case of financial difficulties, is the first property that can be reached by creditors of the partnership. Where property is merely leased to the partnership (see below) and title to that property is still vested in the partner originally owning the property, creditors must exhaust all assets of the partnership before they can reach the assets of the individual partner.

One alternative to an outright contribution of property to the partnership is a <u>lease</u>. The lessor, the owner of the property, receives payment under the lease which must be reported annually as ordinary income. It is important to use a detailed lease agreement. It should include who is responsible for purchasing replacement property, who owns the offspring (if breeding livestock are involved), lease payments and other terms. A lease arrangement not only requires a special agreement, but it also involves separate accounting and tax treatment. A lease or rental arrangement often proves a useful means of providing the partnership with capital resources such as machinery without incurring problems of investment credit recapture if it were sold to the partnership or a partner. It also provides a means under a proportional share arrangement of shifting contributions from use only to rental and thus increasing a junior partner's proportion of profits, since the senior partner will be receiving payment for the use of his equipment, not as profits, but as rent.

A second alternative to an outright contribution is the contribution of the <u>use only</u> of some items. It is important that if the use only of property is being contributed, his intention should be clearly stated: "______________________________ contributes the use and possession only of ________________________ for the duration of the partnership. The property described above shall remain the sole property of ____________________________ and shall not become partnership property." If the use only of property is contributed, provision should be made for the burdens of ownership such as insurance, repairs, and replacement of depreciable items. Likewise, provision for any improvements to the property must be made.

After determining the method by which the partners' personal property will be integrated into the partnership setup, a detailed listing of items contributed or leased to the partnership should be included or attached to the agreement (see FM-220I, pp. 5-6). It should indicate on what basis it is being contributed, its current market value, method and amount of reimbursement and how related ownership costs are to be paid or covered, such as repairs, insurance, and replacement.

3. Real Property - In most farm businesses, real estate accounts for the majority of all capital under control of the business. Like personal property, real property need not be contributed outright to the partnership. It may be rented by the partnership or the partnership may be given the use only of real estate.

If real estate is leased to the partnership, a landlord-tenant relationship is created between the partnership and the land-owning partner. Rent payments are made from partnership funds. All ownership expenses on the property will be paid by the owner-partner from the rent income.

Again, a careful listing and valuation of real estate contributed should be made part of the agreement. Reimbursement and method of paying ownership costs (repairs, insurance, taxes, replacement) should be indicated.

4. Tax Consequences of Contribution of Property

a. Appreciated or Depreciated Property

In general, the outright contribution of property by a partner to a partnership does not constitute a taxable event. As a result, no gain or loss is recognized despite the fact that the market value of the property contributed is either higher or lower than the basis of that property to the contributing partner. The basis of the property contributed to the partnership is the basis of the partner contributing the property. The partner retains the same basis for his partnership interest.

To illustrate, assume Able and Baker want to form a partnership. Baker has a building with a depreciated basis of $10,000 and a fair market value of $17,000. In forming the partnership, Able agrees to credit Baker's capital account with $17,000; the value of the contributed building. Baker has realized a gain of $7,000 on the trade of his title to the building for a partnership interest in the Able-Baker Company worth $17,000. Nevertheless, there is no immediate tax on that gain. The partnership takes a basis of $10,000; Baker's basis in the building, and Baker's basis for tax purposes in his partnership interest (assuming no other contributions) is also $10,000.

Nor is recapture of depreciation on sale, recognized to the contributing partner. It is carried over to the partnership and held for subsequent recognition on a sale by the partnership or upon the sale or other disposition by the partner of his partnership interest.

An investment credit previously claimed by the contributing partner on the property contributed to the partnership is not recaptured as additional tax if the transfer of the property to the partnership is regarded as a "mere change in the form" of conducting business so long as the property is retained in the business and the taxpayer retains a "substantial interest" in the business. Ordinarily, property transferred to a partnership will continue to be used for business purposes similar to the original use that qualified it for the investment credit.

b. Property Subject to a Liability

When property subject to a liability is transferred to a partnership, each partner assumes his pro rata share of the liability. The contributing partner who is released from part of the liability is treated as receiving a distribution of money which reduces the basis of his partnership interest. If at the time of contribution the property contributed is subject to a liability so large that the share which the other partners assume exceeds the contributor's basis for the property, the contributor may recognize gain on the transfer. The amount of the gain will be the excess of the portion of the liability assumed by the other partners over the basis to the contributing partner of his partnership interest. For example, assume Baker's basis for a building is $4,000 and at a time when it was worth $17,000 he borrowed $11,000, mortgaging the building for that amount. Baker forms an equal partnership with Able. Able contributes $11,000 and Baker contributes the $17,000 building subject to the mortgage of $11,000. Baker's liabilities have been decreased by $5,500 due to the partnership taking the property subject to the mortgage. He is, therefore, treated as if he received a distribution of $5,500. Since Baker's basis for his partnership interest was only $4,000 (his basis for the building), the "distribution" of money exceeds his basis for his partnership interest by $1,500. Baker must recognize $1,500 gain on the distribution resulting from his contribution of property subject to a liability. The partnership's basis in the property is now 0.

c. Installment Obligations

If a partner contributes installment obligations which for income tax purposes he has been reporting on the installment method, the contribution to the partnership is not a disposition which requires that the remaining unreported profit be immediately recognized. The partnership will report the postponed gain as it is received and the partners will be taxed on their pro rata shares.

B. Additional Capital Contributions and Advances

The initial agreement determines the capital contribution for each partner at the start of the partnership. Whether partners are to have the right or duty to make additional contributions should also be regulated by the partnership agreement. It is commonly provided that the partners may make additional capital contributions with the consent of the other partners: "Each partner may make additional contributions to the partnership at such times and in such amounts as the partners may agree."

1. Reinvestment of Earnings

In a father-son partnership, the partners may want to gradually transfer partnership assets from the father to the son. This will enable the younger partner to acquire a larger interest in the partnership over time and will reduce death taxes at the death of the father. The plan that the partners develop may take several forms. Gifts

between partners may be made. The younger partner may purchase a portion of the older partner's share. Or the partnership agreement may provide for the unequal reinvestment of business profits.

The above options may be used singularly or in combination to reach the desired goal of increasing the junior partners interest. For example, if the original contributions of a father and son are 75 percent and 25 percent, respectively, and the son annually invests 50 percent of his profits while the father invests 10 percent, in each year the business shows a profit, after 10 years the percentage of ownership will change nearly 8 percent in favor of the son (assuming an initial total investment of $200,000 and an annual profit of 10 percent of the total investment). If the father invested none of his profits, the son's interest after 10 years would increase by more than 10 percent. If the reinvestment provision is combined with a $3,000 tax free gift per year from father to son which is reinvested by the son in the farm, the increase in the son's share would, of course, be even larger. The following provision may be utilized.

"Until the partners agree otherwise in writing, each partner shall leave in the business as additional contributions to partnership capital the following percentages of the profits distributable to him at each annual accounting: _____ , ____ percent; ________ , _______ percent."

One problem with the constantly shifting shares described above is the difficulty of determining on your books the actual percentage of ownership by any partner at any one time. As for income tax purposes, a partner's basis in his partnership interest would be subject to constant upward and downward adjustments during the operation of the partnership. These adjustments are necessary to avoid subjecting a partner to tax already accounted for at the partnership level. For example, a partner's basis is adjusted upward for his share of annual undistributed profits on which he is taxed. If this were not done, a sale of the partner's interest would result in a second tax as part of the proceeds of the sale. One way to avoid this shifting shares problem is to treat excess retained earnings as a loan to the partnership. The partnership would pay interest for the use of this money until such time as a shift in shares is made.

2. Capital Improvements

When real property is contributed outright to the partnership, or when it is owned by the partnership, improvements to the property are owned by the partnership. A more difficult question concerning responsibility for and ownership of new improvements is raised when one or more partners contribute real estate on a rental or use only basis. Two options appear to be open. One approach is for the property owner to finance and pay for new improvements. The partnership would, in turn, pay an appropriate amount annually for its use. The other approach would be for the property owner to retain title for the improvement and secure

appropriate financing. Partnership funds would be used to pay for the facility (principal and interest). No cash rent or use charge would be made during or after the period of the loan. The partnership would be responsible for covering related ownership costs—taxes, insurance and upkeep.

Where improvements are involved, you may want to include penalty clauses in the case of an untimely or early withdrawal of a junior partner. By the same token, clauses relative to options of one partner to buy the other's share may be in order.

C. Capital Withdrawals

Unless specified in the partnership agreement, a partner cannot withdraw his contribution except by unanimous consent of the partners or on dissolution of the partnership. Under some partnership situations, however, it may be desirable for one or more partners to be able to withdraw part of their capital contributions. In a father-son partnership, for example, the father may want to reduce his capital contribution and let the son increase his interest. If, however, the business increases in size, the growth will allow one partner to increase his capital contribution without decreasing another partner's total capital.

In the event that a withdrawal provision is desired, the consent of the other partners should be required. The partnership agreement may also provide for a ratable distribution whenever the partners think a reduction in capital desirable. This is a sample clause: "Any partner may at any time withdraw all or any part of his capital contribution with the written consent of all other partners. In the event that it shall ever be deemed advisable to reduce the amount of capital, the amount of such reduction shall be determined by the managing partners, and the same shall be distributed to the partners ratably, according to their respective interests in the capital of the firm."

IV. Labor and Management Contributions, Duties, Powers and Limitations

A. Labor and Management Contribution

When it is the understanding that all partners shall devote their full attention to partnership affairs, it should be stated expressly in the partnership agreement that they shall do so. The agreement should also define their outside activities. A partner cannot compete with his partnership within the scope of its business. He must account to the partnership for any profits acquired in a manner which injures the interests of the partnership. Below is a sample provision in which the partners agree to devote their full attention to firm business: "Each of the partners shall devote substantially all his time, skill, and attention to the partnership business. He shall give, whenever required, a true account of all business transactions out of or connected with the conduct of the partnership. None of the partners shall engage in any business except that of the partnership, or upon account thereof, without the

written consent of the others, or employ either the capital or credit of the partnership in any other business whatsoever."

A partner who has nothing to contribute but his labor or services may be taken into the partnership. Even though he does not contribute to capital, he may nevertheless be given a percentage of the profits. Provision may be made for his making future contributions to capital. "__________ __________ shall make no cash or property contribution at the commencement of this partnership. He shall devote his full time to the partnership and for such services shall be entitled to twenty percent (20%) of the profits to be divided among the partners. Should his share of the profits exceed ______ dollars, he shall contribute the excess to his capital account in the business until the total amount of such excess contributions shall equal the capital contributions made by each of the other partners."

If a partner receives a share of partnership capital as consideration of services rendered or to be rendered to the partnership, that share represents ordinary income to the recipient for tax purposes. The amount of such income is the fair market value of the property transferred. The time when such income is realized depends on the individual case, including any significant restrictions on the partner's right to withdraw or otherwise dispose of the interest.

B. Management Duties and Responsibilities

1. Duties

Normally, each partner has an equal right to participate actively in the management and control of the partnership. Any differences arising as to ordinary matters connected with the partnership's business may be decided by a majority of the partners. For this purpose, a majority is determined by giving each partner one vote regardless of capital contribution. However, no act contrary to the partnership may be done rightfully without the consent of all the partners.

The partnership agreement, however, may allocate specific managerial duties and include any management provisions that are agreed upon by the partners. In many cases partnership business may be more effectively carried on if management duties are allocated among the partners according to their interests and skills. For example, one partner may be given management rights over the livestock operations while another partner handles the crop enterprise. Each partner may be authorized to make all ordinary operating decisions so long as he is guided by the overall plan for the business. The following provisions may be used to establish such a management structure: "____________ shall serve as general manager of all crop enterprises and ________ shall serve as general manager of all livestock enterprises. The partners shall agree at the beginning of each year upon an overall plan for the business for the forthcoming year, and the general managers shall make all day-to-day operating decisions within the overall plan. Major adjustments in the plan that appear advisable during the year shall remain the responsibility of all the partners."

Alternatively, one partner may assume the responsibility of making all the ordinary management decisions of the farm business. This management structure may be desirable if one of the partners was frequently absent from the business for extended periods. The managing partner's powers may be limited, if desirable, by broad guidelines or by requiring him to consult the other partners. If management is to be vested in one partner, a provision such as the following may be used: "__________________ shall have general control and supervision such as the over the business of the partnership, assigning to the other partners such duties as to him shall seem best. In all matters affecting or relating to the general policy of the partnership and also in any matters of controversy or difference of opinion between any of the partners as to the course to be pursued in the business, there shall be discussion by all and consideration given to the views of each of the partners, but the decision of ________ shall be controlling."

If the partners prefer to share the management duties, they may spell out how decisions are to be made. Voting may be by capital contribution or shares of profits rather than one vote per partner. No matter how the management decisions are made, it is important to establish a management or procedure that avoids or minimizes deadlocks. If each partner has equal voting power, a dispute could arise in any partnership with an even number of partners. One solution is to provide that a deadlock is to be resolved by the vote of a particular partner. Another choice is the inclusion of an arbitration clause: "In the event that any controversy or claim shall arise out of this partnership agreement, such controversy or claim shall be submitted to arbitration by three disinterested persons, one to be elected by each partner, and if there be but two partners, the third arbitrator shall be selected by the two arbitrators thus selected. The decision of the arbitrators is to be final and binding upon all of the partners."

2. Responsibilities to Other Partners

Partners have what the law terms a fiduciary duty to each other. This means that the partners must deal with each other with utmost good faith, fairness and loyalty, rather than as negotiating adversaries. Thus a partner cannot divert to his own use or profit a business opportunity which would logically fall within the business purpose of the partnership, nor can he act in any other manner contrary to the interests of the partnership, such as sell the partnership property. The penalty for such breaches of duty is accounting to the partnership for the profits realized by those acts.

A partner is an agent of the partnership for the purposes of its business, and he binds the partnership by his acts when he carries on the business of the partnership in the usual way. A partner may bind the partnership where he is found to be acting with either express or apparent authority under the partnership agreement. The express authority of a partner to act on in specific matters is derived from the agreement itself. A partner may, however, in absence of express authority to act, have apparent authority to do so. In determining whether a partner has apparent

authority the course of business of the particular partnership such as similar past actions by such partners, and the course of business of similar partnerships in the vicinity are relevant.

The partnership is not bound where the partner so acting actually had no authority to act for the partnership and the person with whom he was dealing has knowledge of that lack of authority. In addition, a partner may not generally assign partnership property for creditors, dispose of the goodwill of the business, or do any other act which would make it impossible to carry on the ordinary business of the partnership, even where the person with whom he was dealing had no knowledge of the partner's lack of authority. These acts are not binding on the partnership since they are generally not with either the express or apparent authority of the acting partner.

A partner can assign his share of the partnership profits and surplus, but this does not of itself dissolve the partnership or entitle the person to whom the profits were transferred to interfere in the management of the business. It merely gives him the profits to which the assigning partner would otherwise be entitled.

3. Suggested Limitations

In order to avoid problems of determining which partner has authority to do what, the agreement should specify the respective duties of each partner. These clauses should be periodically updated where one partner acquires new responsibilities or the business branches into new areas.

a. Spending capacity

In some instances, further limitations are prudent. One common example is limiting by a specified dollar amount the spending capacity of an individual partnership such as:

> "No partner shall make any purchase where the cost of such purchase is greater than or equal to $______without the written consent of all partners."

The partner who acts contrary to this limited authority may still bind the partnership, but will be liable to his partners for any loss caused to the partnership.

b. Debt load of individual partners

Where a partner's partnership interest constitutes a substantial portion of his personal estate, mismanagement of his personal financial affairs may jeopardize his share of the partnership assets. This, in turn, may indirectly affect the partnership interests of the other partners. Because of this, limitations on the personal activities, especially debts, of a partner may also be desirable in some cases and a cautious partner may even want to specify the right to view his partner's personal books.

c. Duties of silent or non-managing partner

When it is the understanding that all partners will devote their full attention to the partnership business, it should be expressly stated in the partnership agreement. By express agreement it may also be provided that one or more partners be relieved of any management or labor duties. Such a provision may be desirable when a silent partner, who contributes money and property to the partnership, has other active business interests which require most of his attention without such specified agreement, state law gives all partners an equal voice in the management and conduct of the partnership business.

d. Others

Specific factors in each individual instance might warrant inclusion of any number of other limitations, but it should be noted that under restraints upon one partner or another may build resentment and jeopardize the chances of partnership success.

C. Records and Accounts

Proper and accurate partnership accounts and records are essential for tax purposes, effective farm management and for the partners' information. Provisions for keeping the partnership records and accounts should therefore be included in the partnership agreement.

1. Who Shall Keep the Accounts

The agreement should specify who is responsible for keeping the records, and it should affirm the other partners' rights to inspect the partnership books. Annual financial reports should also be required. A provision such as the following may be used: "For a salary of $________ per month ___________ shall have the responsibility and duty to establish and maintain the account books and records of this farm partnership for the purpose of showing partnership income and expenses, each individual's contributions and income status, the financial condition of the business, and other information necessary for the effective management of the farm business. At the close of each fiscal year he shall make a full accounting to the partners. The books shall be open to inspection by the partners at any reasonable time."

2. What Kind of Accounts Should be Kept

The kinds of accounts and records that are to be kept should also be set out in the partnership agreement. The business should keep records for management purposes to show the growth of the business, areas of business strengths and areas for improvement. Thus, provision should be made for an annual net worth statement, profit and loss statement, and cash flow summary.

Although original capital contributions are set out in the partnership agreement, separate capital accounts should be maintained showing the ownership interests of each partner. The capital account of each partner will usually consist of his original contributions, any additional contributions and withdrawals from capital. These accounts are necessary to provide for the distribution of profits, if based upon capital contributions, and for income tax purposes when partnership property is sold.

If drawing accounts are to be used as a means of distributing profits, provision should be made for keeping such accounts.

A partnership bank account should be kept and used exclusively for transacting partnership business. The partners may use their separate personal accounts for conducting their personal affairs. This serves to separate the financial affairs between the partnership and the individual partners. Partners may use personal funds to conduct partnership business, but they should be reimbursed from the partnership account. It is also desirable to keep accurate records of to whom payments are made and for what purpose in the partnership checkbook. In order to facilitate such detailed record-keeping, the ability to draw on the partnership account may be limited to the person who is charged with the duty of keeping the partnership records and accounts.

3. What Method of Accounting Should be Utilized?

The partners should agree on the method of partnership accounting. The partnership may keep its accounts on a cash or accrual basis regardless of the accounting method used by the individual partners. The cash basis method of accounting records expenses when actually paid and income when actually received. The accrual method, however, records expenses when incurred, regardless of when paid, and income is entered when earned without consideration of when it is received. The accrual method has the advantage of producing more uniform profit and loss statements from period to period. But the cash basis may be preferable due to its simplicity and since the partners use it in their personal affairs. The choice of accounting method is always limited by the right of Internal Revenue Service to require the use of a method that accurately reflects income.

As discussed earlier, a partnership as such pays no income tax, but it must file a tax return. For this purpose the partnership must have a taxable (or fiscal) year. The fiscal year of the partnership must be the same as that of the principal partner's unless it establishes a business purpose which satisfies IRS. Since most individuals file their tax on a calendar year basis, most partnerships will also be on a calendar year.

V. Partnership Income, Expenses and Annual Settlement

The agreement should clearly state what items are to be included as partnership income and expense and how the financial settlement is to take place at the end of each business year.

A. Partnership Income and Expense

Allocation of particular items of income and expense to the partner or the partnership is important both to prevent dispute between the partners and for income tax purposes. As a general rule for tax purposes, each partner's distributive share of profits and losses is determined in accordance with the partnership agreement. If the agreement is silent as to the allocation of one or more items of income or expense, the partner's share of the general profits and losses as determined by the agreement or state law will determine his share of each separate item.

Allocation of particular items to the partnership or an individual partner may allow some latitude for shifting income.

The allocation of items among the partners by agreement is subject however to an important limitation. A provision for allocation of any special item of income, gain, loss, deduction or credit will be disregarded if the allocation does not have substantial economic effect. If the allocation does not meet this test, the items will be reallocated according to the partner's interest in the partnership rather than the general method of allocating taxable income or loss.

In order to effectuate the above consideration, the partnership agreement should clearly state what items are to be included in partnership income. This can either be done by making an extensive list of items to be included or listing items that will be excluded from partnership income.

Similarly, expenses to be paid by the partnership should be clearly indicated. Normal operating expenses are typically handled by the partnership. The trouble spots may relate to such items as real estate taxes, repairs, insurance and replacement of depreciable items. How these items are to be handled should be specified in this part of the agreement or under the capital contributions section. Also, if buy-sell agreements are funded with insurance, it should be noted whether the partnership will cover premium payments. (Buy-sell agreement and insurance are further explained on p. 45.)

B. Annual Settlement Between the Partners

Once it has been determined what is to be included in income and expense, then the procedure for annual settlement should be clearly laid out. One of the first items to be decided is the question of inventory changes. The author recommends that annual charges be ignored in the annual settlement and only be considered at the termination of the present agreement. This avoids the tedious, judgmental task of valuation. However, a good set of capital accounts is necessary so that the final settlement can be made.

The main thrust of the annual settlement agreement should be to indicate priorities in the allocation of any cash income remaining after paying partnership expenses, including partnership debt payments. Establishing payment priorities will be particularly critical in the case where business profits are not sufficient to reimburse partners fully for their respective contributions. Therefore, you should indicate whether the value of labor and management contributions should be covered in full before paying for the use of capital items. Similarly, it should be decided whether lease payments take priority over interest payments to partners for property contributed on a use only basis. If these amounts cannot be paid in full, it should be noted how the amount available will be allocated among the partners: according to their respective contributions of the items or according to their sharing of profits.

The annual settlement section should also indicate how excess profits are to be shared. That is, will they be shared on a proportional basis: in the same proportion as the partner's contributions or an equal share or 50/50 basis? It should also be noted here as to what proportion of these excess earnings will remain in the partnership as retained earnings.

C. Additional Considerations

As has been indicated above, there is considerable flexibility in deciding upon a desired annual settlement. The following is an elaboration on several items of concern: , (1) salaries and drawing accounts, (2) interest on capital, (3) profits and losses, and (4) annual taxation.

1. Salaries and Drawing Accounts - A partner is not entitled to a salary, except during the winding up of the partnership business, unless the partners have so agreed. An agreement to pay salaries is understandable when the partners devote unequal amounts of time to the business. The payment of salaries may also be desirable when profits are to be distributed annually and the partners are to be prohibited from advance withdrawals of profits. Generally, though, it does not matter whether income to the partners is received as salary or a share of profits.

Whenever the partners agree to pay salaries, the matter should be discussed expressly in the partnership agreement. The agreement should cover such details as to how and when the salaries are to be paid, in what amount whether they should be treated as partnership expenses in determining net profits, whether payments will be made during a partner's disability, and how changes in salary are to be made. Authority for changing salaries is commonly vested in some or all of the partners by the express terms of the partnership agreement.

If salaries are to be paid, it may be important to make sure that they qualify for tax purposes as salaries which are deductible business expenses of the partnership. When salaries are determined "without regard to the income of the partnership," the guaranteed payments are treated as deductible business expenses of the partnership. They therefore

increase the partnership reductions and, in a year when the partnership has insufficient income to cover the guaranteed payments, would give rise to a partnership loss which the recipient would share according to the provisions of the partnership agreement allocating losses.

Another method of distributing funds to partners is through the use of drawing accounts. The partners may be authorized to withdraw part of the business profits for their personal use throughout the year rather than waiting for the annual settlement. The profit not withdrawn remains in the partnership for re-investment and payment of debts. As with salaries, if drawing accounts are to be established, provision should be made in the partnership agreement.

2. Interest on Capital - A partner is not entitled to interest on his capital contribution unless the partners agree to pay such interest. If the partners agree to share profits equally, or in a manner that does not reflect disproportionate capital contributions, the payment of interest may provide a means of achieving a more equitable return. From an income tax point of view, nothing is gained by interest payments to a partner. The entire amount payable to each partner—salary, share of profits and interest—is taxable to him. He gets to deduct only the portion of interest which his share of the partnership paid.

3. Profits and Losses - The sharing of profits is the essential element for the existence of a partnership. Unless the partners otherwise agree, profits are to be shared equally among the partners regardless of capital contributions. While the sharing of profits need not be spelled out in the partnership agreement, it is desirable to do so.

The proportions in which the partners are to share in profits (and losses) are subject to an infinite number of variations. Profits may be distributed according to labor and management and capital contributions. This ensures that all profits are treated equitably. Equal shares of profits may be desirable. The partnership agreement may stimpulate that all net profits up to an established amount per year are to be distributed according to fixed percentages with all net profits above that figure shared equally.

Unless otherwise agreed, the law is that losses are shared in the same proportion as profits. Particularly in a father-son partnership, this may not be appropriate. It might be preferable in some cases for the father to absorb a disproportionate share of losses. If losses are not to be shared in the same proportions as profits, the partnership should contain an express provision allocating losses. It should be noted that provisions in the partnership agreement as to the sharing of losses are effective only among the partners and can have no effect on the liability of a partner to partnership creditors.

In some cases it may be desirable to require that a certain percentage of each partner's share of profits be contributed to the partner-

ship as additional capital. As we discussed earlier, if unequal reinvestment of profits is provided for, it ultimately results in a shift in the capital contributions of the partners. If this is not desired, the equal reinvestment of profits will provide a ready fund for expansion of the farming enterprise.

If advance withdrawals of profits are to be permitted, the amount which may be withdrawn during each period should be fixed to prevent overdrawing of a partner's share of the profits. And if the business venture is speculative, advance withdrawals of profits should be carefully considered.

VI. Partnership Dissolution: Business Liquidation or Continuation

A partnership is dissolved when a partner ceases to be associated with the partnership. However, the dissolution of the partnership does not necessarily require liquidation of the business. If properly drawn, provisions are included in the partnership agreement so the business can continue. The partnership agreement should provide for the most likely causes of dissolution by prescribing procedures for liquidation and distribution of the business assets or providing for purchasing a departing partner's share of the partnership assets.

A. Causes of Dissolution

Technically, the partnership is dissolved whenever any general partner ceases to be such. Dissolution of the partnership is inevitable but dissolution of the partnership business is not. Upon dissolution the partners have three choices regarding the business: (1) they may wind up the partnership and liquidate the business; (2) they may continue the business as a new partnership or (3) they may continue the business in a different business form.

A farm partnership may be dissolved by the happening of any of several events. The appropriate action to be taken following dissolution depends upon the cause of dissolution. Thus the partnership agreement should provide for the most likely causes of dissolution.

1. Unanimous Covenant

A partnership may be dissolved voluntarily by the unanimous agreement of the partners. The agreement should provide for voluntary dissolution upon conditions agreeable to the partners and direct how partnership assets will be distributed. Voluntary dissolution usually results in liquidation and termination of the business.

When a partnership is formed the partners may agree that it is to be continued for a definite term of years. At the end of this period the partnership is dissolved. As discussed earlier, a specified term

may be used as a means of providing for periodic re-evaluation of the business. To do this the partnership agreement may provide that the partnership will continue automatically for successive terms unless a partner gives notice of his desire to dissolve the partnership prior to the specified date.

2. Withdrawal of Partner

Continuation of the partnership is dependent on the consent of all the partners. The right of a partner to dissolve the partnership by withdrawing cannot be abrogated by the partnership agreement. However, if the withdrawal of a partner would likely injure the partnership business, the agreement may provide for damages to be paid to the remaining partners. If the partners intend to allow withdrawal from the partnership under specific conditions, the agreement should specify the the conditions: "Any partner may withdraw from the partnership at the end of any fiscal year by giving written notice to the other partners at least ____ months (days) prior to the expiration of the partnership agreement or any renewal."

3. Retirement

The retirement of a partner is a planned withdrawal from the partnership. Retirement of the senior partner is likely to be a very important consideration in most father-son or son-in-law partnerships because of the age difference in the generations, and the partnership agreement should contain provisions which carry the retirement plan into effect. Such provisions should be integrated with the overall estate and tax planning of the senior partner. The latter considerations are well beyond the scope of this work. Generally, among themselves the partners may agree upon any arrangements they see fit, but tax consequences play an important consideration.

4. Insanity or Physical Disability

While insanity or other personal disabilities do not generally dissolve a partnership, in farm partnerships the partners should consider the effect of incapacities such as insanity or physical disability. If the partners desire to dissolve the partnership should one of the partners become incapacited, the partnership need not be liquidated. And if the partners desire to continue the partnership, the disabled partner's diminished contribution may be reflected in a reduction of profits.

5. Death

The death of a partner dissolves a partnership. Death of a partner is the most common cause of termination of partnerships. Unless provision is made in the partnership agreement, death means liquidation of the business.

B. Liquidation of Partnership Business

The partners may prefer to wind up the partnership and liquidate the business upon dissolution, or liquidation may be provided for when the partnership is dissolved for certain reasons such as the voluntary dissolution of the partnership on the end of the partnership term.

1. Supervision of "Winding Up"

It can be agreed that one partner should wind up the partnership affairs and supervise the liquidation. Without such an agreement partners have equal rights to wind up the partnership affairs. If one partner is to supervise the winding up of the partnership affairs, the authority of other partners to speak for and bind the partnership is ended for those persons with actual notice or changeable with notice of their lack of authority. A remaining partner is entitled to reasonable compensation for his services in winding up the partnership affairs.

2. Priority of Distribution of Liquidated Assets

The partners cannot alter the priorities established by law for the payment of partnership creditors. But among themselves they may agree to any order for the payment of liabilities owed them by either the partnership or each other and for the payment of surplus among them. Generally, it is preferred to distribute the partnership assets in kind to the partners if it is feasible since sale of property results in a realizable taxable event. Below is a sample clause providing for distribution of partnership assets upon liquidation: "The business of the partnership shall be wound up and liquidated as rapidly as business circumstances and orderly business practice will permit. The assets shall be applied in the following order: (1) to the payment of all expenses of liquidation; (2) to the payment of the debts and liabilities of the partnership owing to creditors other than partners; (3) to the payment of all debts and liabilities owning to partners, other than for capital and profits; (4) to the repayment of the capital contributed by the partners, the partners to share the remaining assets if they shall not be sufficient to repay such contributions in full pro rata, according to the ratio that their respective contributions bear to the amount of all the contributions; and (5) the surplus, if any, of the assets remaining shall be divided among the partners in the same proportion as that to which they are

entitled to share in the profits of the partnership."

3. Tax Consequences

As a general rule, gain or loss is not recognized to either the partners on the partnership upon a distribution of property that liquidates the partnership. There are three exceptions to this rule and we will discuss them separately. First, gain is recognized to a partner on such liquidating distributions when a cash distribution exceeds the basis of his partnership interest. A means of postponing the recognition of gain is to include property other than money in the distribution. This delays any recognition until the property is disposed of by the partner.

Second, loss is recognized to a partner when the distributed assets consist only of cash, unrealized receivables and inventory. The loss in such cases is limited to the excess of the recipient's basis for his partnerhsip interest over the sum of the money received plus the partnership basis for the distributed property. In computing the loss, the partner's basis would first be reduced by any cash in the same distribution.

Third, a non-pro rata distribution of unrealized receivables on substantially appreciated inventory is treated as a taxable sale or exchange between the partner distributee and the partnership. When the partnership has made the "sale," its gain or loss is the difference between the adjusted basis of the receivables and inventory "sold" and the market value of the partner's interest in the retained property. When the partner has "sold" his receivables and inventory to the partnership, his gain or loss is the difference between his pro rata adjusted basis of the receivables and inventory left with the partnership and the market value of the other property received. The "buying" party of the receivables and inventory will be treated as a purchaser for cash, and therefore not subject to tax, if such property is acquired for money. If a distributee partner takes receivables and inventory in release of his interest in other partnership assets, his gain or loss would be the difference between his share of the adjusted basis of the other partnership assets and the market value of the receivables and inventory received.

Partnership distributions may be made in kind as well as in cash. For such distributions the separate identity of the partnership and the partners is ignored. Since gain is recognized only upon a distribution of money (absent a non-pro rata distribution of receivables and inventory), and loss is recognized only upon a distribution confined to money, unrealized receivables and inventory, if a partnership distributes its assets in kind, the partners realize no gain or loss until they dispose of the property. The partners merely take what they already own.

Generally property other than money distributed by a partnership in a liquidation will have a basis to the partner equal to the partner's

adjusted basis for his interest in the partnership reduced by the amount of any money distributed in the same transaction. The basis of the partnership interest must be allocated among the assets other than money distributed. If the money distributed exceeds the basis of the partnership interest, gain is recognized and no basis remains for allocation to the other assets. If there is a basis for the partnership interest in excess of money distributed, that basis is first allocated to any unrealized receivables and inventory items distributed in an amount equal to the adjusted basis of each to the partnership. If there is still basis for the partnership interest remaining after reduction for money distributed and after allocation to unrealized receivables and inventory items, it is allocated among assets distributed in proportion to the basis of those assets to the partnership.

The holding period to a partner of most property received by him in a distribution from a partnership will include the holding period of the partnership for that property. This "tacking" of holding periods does not apply, however, in determining the period for which a partner has held inventory items received from the partnership.

In most cases the taxable year of the partnership does not close with respect to the survivors upon the death of a partner but continues until the end of the partnership's taxable year. The income from the end of the last taxable year before the partner's death up to his death will be reported in the income tax return of his estate for the year with which or within which the partnership year ends. This may deprive the decedent's estate of the tax benefits of splitting income with a surviving spouse and of offsetting the decedent's share of partnership income by any personal deductions he may have had. However, if the partnership agreement calls for the sale of the decedent's interest to the remaining partners on the day of death, then the taxable year of the partnership closes with respect to the decedent on the date of death, the decedent's distributive share of partnership income to the date of death will be reported in his final return. This provides a means of obtaining the benefits of a joint return and to offset the deductions of the decedent.

C. Continuation of Business

While withdrawal, retirement or death technically dissolves the partnership, when it is the desire of the partners that the business be continued, the business need not be liquidated if an appropriate provision is contained in the partnership agreement. In most cases the partners are ill-advised if they do not provide for continuation of the business upon the voluntary withdrawal or death of a partner. The continuation plan should aim to provide for the continued operation of the business by the remaining partners without interruption and to assure the withdrawing partner that he or his estate will receive the fair value of his interest without delay or risk. The continuation plan should also assure that the liquidation of the withdrawing or deceased partner's interest does not impair the ability of the business to continue functioning.

1. Continuation Upon Withdrawal or Incapacity of Partner.

a. Purchase by Other Partners

When a partner voluntarily withdraws from the partnership or retires, the partnership agreement should give the remaining partners an option, not a binding agreement, to purchase the withdrawing partner's interest at a stated price or according to a formula. A similar procedure may be employed in the event of the incapacity of a partner if the parties desire to dissolve the partnership on the happening of such events. A common provision is to give the remaining partners an option to purchase at an agreed price or according to a formula with payments made in installments over a period of years at a moderate rate of interest. The method of determining the purchase price will be discussed below. The provision should certainly be stated as an option to purchase rather than a binding agreement since the remaining partners may find it unprofitable or impracticable to carry on the business upon the withdrawal of a certain partner. Should the remaining partners fail to exercise their option to purchase, the partnership would of course be liquidated.

A variation of this provision would provide for the payment of a share of the business profits over a period of years as payment for the withdrawing partner's interest. However, if this method of payment is adopted, provision should be made for compensation of the active partners for their services. Such compensation should be treated as an expense of the partnership in determining the withdrawing partner's share of profits.

If there are prohibitions against withdrawal, or limitations upon the right to withdraw, penalties may be provided for their breach. For example, the option to purchase may be cast in terms favorable to the remaining partners or damages may be required.

b. Purchase by Non-partner Third Party

Rather than provide for the purchase of a withdrawing or retiring partner, the partners may agree to adopt a corporate method to provide for the continuity of the business. The partnership agreement may provide that a partner may sell or assign his partnership interest with, or without, the consent of the other partners. (The consent of all partners would be required for the buyer to become a partner, however.) This right to transfer may be absolute and unqualified. However, this purely corporate approach would probably not be appropriate in a farm business partnership. A more appropriate provision would allow the transfer of a partner's interest subject to restrictions on the purchaser's rights to management or control. Or a limited partnership may be formed upon the transfer of a partner's interest, with the purchaser becoming a limited partner rather than a general partner.

2. Continuation Upon Death of a Partner

Death of a partner is probably the most common cause of termination of partnerships. Continuation of the business may be provided for by

giving the surviving partners the right to continue the enterprise by purchasing the deceased partner's interest or by making the deceased partner's estate a partner.

a. Making the estate a partner

In some cases it may be desirable to continue the partnership business by allowing the deceased partner's personal representative, and perhaps ultimately his heirs or beneficiaries, to retain his interest in the partnership. To provide for this method of continuation of the partnership business, the partnership agreement should provide that the estate of the partner will continue to participate in the profits and losses of the partnership. The partner's will should also authorize participation in the partnership by his personal representative. While state law authorizes a personal representative to continue a partnership, it is preferable that the will expressly give the personal representative such power. Even with such a provision, many personal representatives would be reluctant to assume such duties.

Making the estate a partner may be an equitable management in many cases. It may be viewed as compensation for the past services of a deceased partner payable after his death. It reflects the contribution to the profits of the business made by a deceased partner even after death through income received from his unfinished business. To reflect these contributions, the partners may wish to make the estate of a partner a partner for a limited period of time. However, in most cases these objectives may be met with less risk to the personal representative and the estate. For, if the estate is a partner, all estate assets may be subject to potential loss due to the unlimited liability of the partnership form. The personal representative may be subject to both surcharge by the heirs or beneficiaries and personal liability for partnership losses.

There may be other ways to retain the deceased partner's interest in the partnership. For example, the business may continue with the partnership interest retained in the business operated by the surviving partners. But since the personal representative or the heirs of the deceased partner will have neither management rights or a right to share in profits, the only advantage of such a provision is the accommodation of the surviving partners.

b. Buying decedents share by surviving partners

In general, retention of the partnership interest after the death of a partner is likely to create difficulties. A partnership is a close personal relationship and may not bear the introduction of a stranger who has not lived with it as it has grown. There may, thus, be several good reasons for arranging the sale of the decedent's interest to the surviving partners by a pre-arranged agreement. Such an agreement assures a ready market, a source of funds and the means of determining the purchase price.

If the partners decide that on the death of one of them there should be an agreement providing for the acquisition of his interest by the survivors, they will have to make several decisions. Who will be permitted to purchase? To what degree will the agreement be binding on the various parties? What will be the price and the terms of the sale? How will the agreement be funded? Consideration of the financial and physical status of the partners and of their goals and desires for the agreement will allow formulating the plan best suited to their needs.

In the normal buy-sell arrangement, the parties will arrange to purchase a pro rata part of the withdrawing or deceased partner's interest so as to retain their relative participation with the survivors. Arrangements may be made for many variations on this approach. A younger partner may be allowed to increase his contribution to the partnership. An outsider whose services will be needed if a particular partner should die may be permitted to "buy-in". In a father-son partnership, only the son may be allowed to purchase his father's interest in order to continue the business while providing funds for other heirs.

Once the purchase rights are determined, there must be a decision as to whether the obligations on the buyer and seller should be mandatory or merely optional. Purchase plans generally take one of two forms: (1) an agreement that upon the death of a partner, his interest shall be owned by the surviving partners who will pay a price determined in the agreement or (2) an agreement that the remaining partners shall have the option to purchase the interest of the deceased partner. In the first type of agreement the interest of the deceased vests in the surviving partner immediately upon death and does not pass into the estate of the decedent. Such an agreement assures a market for the sale of the interest. However, if the survivors bind themselves to purchase the decedent's interest they may be forced to do so even though it has become unprofitable to operate the business without the decedent. The second arrangement, giving the surviving partners an option to purchase the decedent's interest, provides more flexibility. It is impossible to accurately predict the future. An option allows the surviving partners to determine what is best after the death of a partner. However, the partners may prefer an absolute buy-sell arrangement to assure that their heirs will receive the fair value of their partnership interest.

3. Tax Consequences

If a plan to continue the business following the retirement or death is to be included in the partnership agreement, the tax consequences of such a plan must be considered. Payments made in liquidation of the interest of a retiring or deceased partner in partnership property are treated as liquidating distributions. This means such payments will result in capital gain or loss measured by the difference between the amount of cash recovered and the basis of the partner's interest in the

partnership. However, payments attributable to unrealized receivables will result in ordinary income treatment. And payments for goodwill will also result in consideration as ordinary income except to the extent that the partnership agreement specifically provides for payment for goodwill. If any part of the payments result in ordinary income treatment to the recipient, the payments may be either excludable in computing the distributive shares of the other partners or deductible. If the distribution to a retiring partner or a deceased partner's estate is a series of payments to be made over more than one year, each payment must be allocated between the portion which is in exchange for the partnership interest in partnership property and the ordinary income portion.

4. Paying Off the Withdrawing Partner

Whether the buy-sell plan is mandatory or optional, the value of the decedent's or retiree's interest must be determined and agreed upon. This is one of the most important and difficult aspects of developing a buy-sell agreement. Many different formulas are used in determining the value of a partner's interest. The one that is used depends upon the facts and circumstances of each case. Regardless of the means used to determine value, the surviving partner must be able to perform their part. If the purchase price is beyond the capabilities of the surviving partners, the agreement is ineffective and nothing has been accomplished by it. On the other hand, the retiree or the decedent's heirs are entitled to the fair value of the decedent's interest. Finally, when determining the value of a deceased partner's interest, the Internal Revenue Service and the State Department of Revenue cannot be overlooked. The value used in the buy-sell agreement will have important tax consequences.

a. Methods of Evaluation

The partners may agree upon the value of the business. This may be done when the partnership is established and periodically during the operation of the business. The theory behind this method of valuation is that the partners are best able to value their own business. The method is generally fair since each partner does not know if he will be required to buy or sell under the agreement. A disadvantage of this method is that the value may be inaccurate if the partners fail to periodically revise the value. And where it is apparent that one partner is likely to sell his interest first, the other partner may tend to move slowly toward any increase in valuation.

Since the value of a deceased partner is to be determined as of the date of death, a desirable method for determining value is to provide for appraisal of the business by disinterested and competent appraisers. This method simply places the burden on the third parties chosen. The partners should determine the factors to take into account in determining value. This method also fails to take into account the earning capacity of the business.

A third and perhaps the most common method of determining value is to specify "book value" in the buy-sell arrangement. Book value is the net worth of the partnership, the difference between assets and liabilities. Since book value does not ordinarily take into account the appreciation of assets, it may vary greatly from actual value and, hence, may be unfair. But it may be adjusted in order to more accurately reflect the true value of the business. If such adjustments are to be made, they should be expressly stated in the partnership agreement so as to define precisely what is meant by "book value". In order to avoid closing the books as of the date of death, book value as of the end of the fiscal year immediately before or after death is usually used. This value may or may not be adjusted.

A final means of determining the value of the decedent's interest is by means of a formula. Average earnings over a representative period may be capitalized at a multiple of earnings to determine the value of the business. Difficulties are presented in determining the representative period and the multiple to be used. And this method does not take into account the possibility that past earnings may have distorted for any of several reasons.

The partners may decide that none of the four methods of valuation are appropriate for their farm business. In that case a combination of the methods may be used. For example, the partners may decide to use an agreed value plus interim increases or decreases in book value since the date of the last agreed valuation. Livestock and grain may be valued at the average market price over the preceding six months. The variations available are endless. Despite the fact that establishing a purchase price for a decedent's interest is difficult, it should be kept in mind that the time to determine value is at the formation of the partnership when all partners are able to participate in the decision.

Regardless of which method is used to determine value, there are two other factors in determining value which must be considered. Intangible assets such as goodwill may be involved in a business. These assets are frequently difficult to evaluate and there are several approaches to the problem. It may be expressly stated that such assets are not to be included in determing value. An arbitrary value may be given such assets. Finally, the value of the goodwill may be determined by a formula such as a multiple of average annual earnings.

Another consideration in establishing value involves the extent to which life insurance proceeds should be reflected in the purchase price. If it is contemplated that the partnership will maintain life insurance on the partners to provide a fund for the purchase of a decedent's interest, the proceeds of the policies may be included in the value of the decedent's interest. Generally it is desirable to exclude the proceeds of such policies from the purchase price. Otherwise, the fund for the purchase will be inadequate in most cases. A simple way to accomplish this is to provide that the value is to be determined as of the month preceding death.

b. Methods of payment

Once the purchase price has been established, provision must be made for payment. It is unlikely that the remaining partners will have the means to pay a substantial sum in cash. It is often agreed that payment will be made in a series of equal installments. The provision setting forth the installments may specify what security will be given by the surviving partners to insure that the installments are paid when due. It may be provided that the amount of the unpaid installments constitute a lien against partnership property, that upon default in making payment all future may be accelerated, or that upon default at the election of the decedent's personal representative, the partnership may be liquidated. Even if adequate security is provided, however, there are some disadvantages to an installment payment plan. Distribution of the decedent's estate may be delayed until the final payment is made. And the surviving partners are burdened with making periodic payments that are not deductible in determining their income tax.

A more practical solution for both the estate of the deceased partner and the surviving partners may be life insurance. For the surviving partners life insurance provides a definite sum with which to finance the purchase of the decedent's interest at the required time. For the estate of the decedent, it provides immediate payment in cash. The amount of insurance to be taken out on the life of a partner depends, of course, upon the value of his interest. Upon the death of a partner, the surviving partners should take out more insurance to reflect the increased value of their interests in the business. Cash value insurance is generally preferred over term insurance since term insurance becomes prohibitively expensive as the partners become older. It is often provided that the surviving partners have the option to purchase the policies insuring their lives owned by the decedent at the time of his death.

If a partner is uninsurable the other partners, instead of maintaining insurance on his life, may deposit an amount equal to the premiums of such insurance if available in a separate account. If the uninsurable partner should die prematurely, the partnership agreement may provide for installment payments of the balance of the purchase price.

There are two types of life insurance buy-sell plans, the "cross-purchase agreement" and the "entity purchase agreement". Under the cross-purchase plan the life insurance used to fund the agreement is provided by each partner purchasing, owning and being beneficiary of a policy on the life of each of the other partners. In the entity purchase plan the partnership itself purchases, owns and is beneficiary of one policy on the life of each partner. Proper use of either method will prevent inclusion of both the insurance proceeds and the partnership interest in the deceased partner's gross estate for estate tax purposes. And in either case the premiums will not be deductible for income tax purposes.

After determining the appropriate provisions for liquidation or buying out upon retirement or death, those provisions should also be cleared with the wives of the partners, since they too have a stake

in insuring themselves adequate income to provide for a comfortable retirement or widowhood, and may be able to dispute the agreement if it provides for their interests inadequately.

VII. Miscellaneous Provisions

A. Arbitration

Provision should be made for the arbitration of any disputes relative to the formation, operation or dissolution of the business. Such a clause should provide that controversies or claims that cannot be settled by the partners be submitted to arbitration. The arbitrators would normally be selected as follows: each partner would select an arbitrator and the selected arbitrators would, in turn, select another. The partners would agree to bound by the decision of the arbitrators.

Any number of other provisions may be desired by the partners and inserted in the partnership agreement. A few of the items that may be considered are discussed below.

B. Housing of Partners

Provisions for housing of the partners and their families are especially desirable in a family farm partnership. Such provisions may prevent a possible dispute in the future when, for example, the son wants to build a new house and use partnership funds to do so. The following is a sample clause that may be included: "Each partner shall provide his own housing for himself and his family. If_______________provides the necessary housing for_______________, he shall pay rent to_______________as mutually agreed upon. If_______________is single and lives with_______________, he shall pay room and board as mutually agreed upon."

C. Vacation and Time Off

While the partners in a farm partnership will usually devote their full attention to the farming enterprise, everyone needs an occasional vacation. And time off during the week is also required. A provision may be inserted in the partnership agreement to provide for vacations and time off. It may provide: "Each partner shall have every other Saturday afternoon and Sunday off, except during crop planting and harvesting, unless otherwise agreed. Each partner shall be entitled to two consecutive weeks of vacation each year."

D. Expense Accounts

Partners may often incur personal expenses while on the business of the partnership. By law the partnership is obligated to pay expenses incurred by individual partners on behalf of the partnership in the

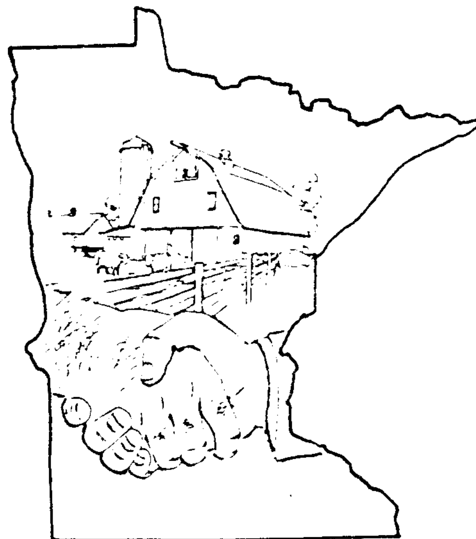
absence of a contrary agreement. A provision reflecting this duty may be desirable. A simple provision would be: "Travel and subsistence expenses of partners incurred in the conduct of partnership shall be reimbursed, therefore, from partnership funds. The partner shall present an itemized statement of his expenses before receiving reimbursement."

E. New Partners

When forming a family farm partnership, it may be desirable to provide for adding younger members of the family when they reach a certain age. This could be done by drafting a new agreement at that time. This may be required if the partner will make contributions of property to the partnership. However, if the later inclusion of another partner is contemplated at the time of forming the original partnership, the agreement can include a provision concerning the terms of admission of new partners.

APPENDIX

Farm Partnership Agreement Worksheet



Note To Partners:

One of the keys to a successful partnership arrangement is the development of a sound written agreement. This worksheet is designed to aid you in doing your "homework" as to the type of arrangement you would like to operate under. However, to insure that your agreement is complete and sound legally and tax-wise, you should secure the help of an attorney and accountant. The partnership is an extremely flexible tool, so get some good help so you can take maximum advantage of it.

Note To Attorney:

This worksheet has been developed to aid your clients in making some preliminary decisions as to the type of agreement they would like to operate under. Obviously, they will be seeking your advice and counsel regarding various aspects of their agreement.

As you finalize their agreement, you will likely want to place the provisions which are not subject to change in the body of the agreement. Items which will likely change over time should be placed in a set of exhibits to be attached to the basic agreement.

Kenneth H. Thomas
Extension Economist
Farm Management

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Area Extension Agent
Farm Management

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PRELIMINARY STATEMENTS

1. What are the names and addresses of the partners?

   Name________________ Address________________
   ________________ and

   Name________________ Address________________
   ________________ and

   Name________________ Address________________
   ____

2. What name (if any) has been selected for the partnership?________________
   ____

3. Where will the partnership have its principal place of business?________________
   ____

4. In broad general terms, what farm activities will the partnership engage in? (note any limits also) ________________
   ____

5. Note any plans for becoming involved in other business activities.
   ____

6. This partnership agreement will take effect on:________________

7. How long will it run?________________

8. Is it to be automatically renewable?________________

9. When and how must notice of termination be given?________________
   ____

10. An annual review of the partnership, including progress, relationships, arrangements and future plans should occur: ________________

INITIAL CAPITAL CONTRIBUTIONS, ADDITIONS, WITHDRAWALS

Initial Capital Contributions

Capital contributed by the partners to the partnership may include cash, personal property and/or real estate. These items may be contributed in any one of three ways: (1) outright transfer of property to the partnership, (2) on a use only basis, and (3) on a rental basis. Attach worksheet FM 223 as part of Exhibit A, recording the capital contribution of each partner. It should also be noted on what basis the various items will be contributed.

1. Who shall be responsible for normal repairs, maintenance and insurance on personal property contributed on a use-only basis?____________________

____

2. Who shall be responsible for replacement of depreciable personal property?

____

____

3. Briefly describe any real estate property that is to be rented to the partnership or contributed on a use-only basis. Also, indicate who will be responsible for payment of taxes, insurance and normal repairs.

____

____

____

Additional Capital Contributions

1. Under what conditions can a partner make additional capital contributions to the partnership?

____

Shall such additions (1) call for a recalculation of contributions and profit shares (__) or (2) compensation through the use of an interest bearing note (__)? Check one. Interest rate on notes shall be ______%.

2. Will there be any limitations on partners leaving undistributed profits or annual use charges in the partnership?

____

If the retained earnings exceed a partner's share of profits, such retention will (1) call for a recalculation of contributions and profit shares (__) or (2) compensation through the use of an interest bearing note (__). Check one. Interest rate on notes shall be_______%.

3. If major improvements or additions are made on a given partner's property, who will own them? ____

How will they be paid for?____

Withdrawals Of Capital Contributions

1. Under what conditions can any partner withdraw part of his contributions?

____

____

____

____

LABOR AND MANAGEMENT CONTRIBUTIONS, DUTIES, LIMITATIONS

Labor And Management Contributions

1. The amount and value of each partner's labor and management contribution should be noted in the agreement.

2. What non-partnership work, if any, may a partner engage in?

   ____

Management Duties

1. Indicate those situations, if any, under which the partners will not have an equal voice in management and what the arrangement will be.

   ____

   ____

2. How will disagreements be settled?______________________________

   ____

3. How are management duties to be divided as regards the daily management of the business?

   ____

   ____

4. Will an overall farm business plan be developed each year to serve as a guide in management? If so, what shall it contain, and who will develop it?

   ____

   ____

5. What happens if a partner is unable to perform services assigned to him?

   ____

   ____

   ____

   ____

Limits On Powers Of Partners

Because partners have unlimited liability in a partnership, generally a substantial list of limits are placed on the personal and business activities of a partner. The following is an example list. Check it over, make any changes you would like to see in your agreement.

Without the consent of the other partner or partners, no partner shall:

Limits to powers relative to existing property

1. Make, execute or deliver any assignment of partnership property for the benefit of creditors.
2. Contract to sell or lease all or substantially all of the property of the partnership.
3. Submit a partnership claim or liability to arbitration.
4. Confess a judgment against the partnership or any of his partners.
5. Dispose of the goodwill of the business or do any other acts that would make it impossible to carry on the ordinary business of the partnership.
6. Sell, mortgage, lease or assign any partnership real property.
7. Compromise any claim due the partnership.
8. Sell, mortgage, lease, assign or pledge his interest in the partnership nor his interest in his separate property contributed for the use of the partnership, except his partner.

Limits to powers relative to property acquisition and debt

1. Contract or incur expenses or indebtedness on behalf of the partnership in any transaction involving more than $________.
2. Purchase securities on margin or invest in grain commodity markets.
3. Borrow or lend money on behalf of the partnership.
4. Borrow more than $______ annually for personal use except for the purchase of real estate.
5. Incur unsecured personal indebtedness exceeding $_______ in the aggregate.

Limits to powers relative to personnel and other parties

1. Carry on or have an interest in any other business, including other farming.
2. Hire or dismiss any hand or other employee except those employed for periods of time less than two weeks.
3. Admit a new member to the partnership.
4. Act as surety, guarantor or accommodation party to any obligation in the name of the partnership.
5. Act personally as a surety, guarantor or accommodation party.

PARTNERSHIP INCOME, EXPENSES, ANNUAL SETTLEMENT, RECORDS AND ACCOUNTS

Partnership Income

1. Except for the following, all other income shall be considered partnership income:

   ____

Partnership Expense

1. Business expense items to be paid for by the partnership are noted in Exhibit B - FM 224.

2. Cash withdrawals from the partnership by each partner shall be made on ________ basis. The withdrawal amount shall be as follows:

______________________ (name)	$______________ / ___________
______________________ (name)	$______________ / ___________
______________________ (name)	$______________ / ___________

3. Withdrawal amounts may be changed at any time but only after obtaining the consent of the other partners. ____

Inventory Changes

1. Are inventory changes to be considered on an annual basis or for the period of the agreement?____________

2. How shall increases be shared?____

____

Annual Settlement

1. Indicate the priority for paying the following: partnership expense, including debt service _____________; labor and management charge _____________; interest or rent on property leased or provided on a use-only basis ____________; depreciation due partners _____________; loan by partners ____________.

2. Remaining profits shall be shared as noted in Exhibit B - FM 224_________

____

Records And Accounts

1. Where will partnership funds be deposited?_______________________________

2. Who will be empowered to draw on the partnership account?________________

____

3. What accounting system will be used?____________________________________

4. Will records be kept on a cash or accrual basis?__________________________

5. Who will be responsible for keeping accounts?_____________________________

Will they be reimbursed?____

Who will do the tax work?____

6. When will the records be open to inspection?______________________________

7. What types of accounts shall be kept?

   Drawing account? _____ Capital account? _____ Cash flow? _____

8. What types of annual statements shall be provided?

   Net worth? _____ P & L? _____ Cash flow? _____

PARTNERSHIP DISSOLUTION: BUSINESS LIQUIDATION OR CONTINUATION

Dissolution of a partnership arrangement occurs when a partner departs from the partnership for any reason such as withdrawal, retirement, disability or death. However, the partnership business may or may not be terminated.

Indicate the desired disposition of the partnership business upon the dissolution of the partnership.

	Disposition Of Business	
Reason For Dissolution	Liquidation	Continuation
Mutual agreement	____________	____________
Expiration of term	____________	____________
Partner withdrawal	____________	____________
Retirement of partner	____________	____________
Incapacity of partner	____________	____________
Death of partner	____________	____________

Liquidation Of Business

1. How shall the person be selected to handle the winding up of the partnership business? ____

   ____

2. In carrying out the liquidation, what shall be the priorities in distributing partnership assets? ______________________________________

   ____

3. How shall property remaining in the capital account be shared?__________

   ____

Continuation Of The Business

1. If a buy-sell arrangement is to be part of the agreement, under what conditions will it be triggered? ____________________________________

   ____

2. Will the buy-sell be mandatory or voluntary upon the remaining partners? __________. If mandatory, how soon must the buy-sell be exercised?______

   ____

   What will be the terms of the arrangement?______________________________

   ____

3. How will the value be established and payments made for:

   personal property:____

   ____

   real property:____

   ____

4. Will life insurance be used to fund part or all of the buy-sell agreements? ____

5. Who will own and pay for the insurance policies?__________________________

   ____

ARBITRATION AND MISCELLANEOUS ITEMS

1. How shall disagreements be arbitrated?__________________________________

   ____

   ____

2. How will partners' housing be handled?__________________________________

   ____

   ____

3. How will partners' vacations and time off be handled?____________________

   ____

   ____

4. Is provision for admitting a new partner desired?________________________

   ____

   ____

5. How will partners be reimbursed for personal expenses incurred on behalf of the partnership? ____

   ____

   ____

6. Do the wives of each of the partners understand and consent to the provisions of the agreement? yes______ no______