

# Chapter 16.

## Partnerships

Most family timberlands have been traditionally operated as sole proprietorships or in joint fee ownership. Increasingly, however, nonindustrial woodland owners are turning to partnerships and corporations as ownership vehicles, particularly if two or more persons are involved in the ownership or management. This is due in part to the increasing financial values associated with managed woodlands and the desire to utilize prudent business and income tax practices. However, there is also a special interest in using partnerships and corporations for estate planning purposes.

A key factor in selecting a form of organization is whether it is intended that the tree farm operation will continue beyond the lives of the current owner(s). If this is not the case, sole proprietorship may be the best device. But if it is expected that the tree farm as an entity will continue into the next generation, a corporation or partnership may be a better choice. Partnerships will be discussed in this chapter, corporations in chapter 17.

### DEFINITION OF A PARTNERSHIP

A partnership is generally defined as an association of two or more persons, as coowners, to operate a business for profit. Tests for determining what is and what is not a partnership have been developed in each State. Written partnership agreements are not necessarily required if the actions of the parties involved and the attributes of their relationship are sufficient to indicate partnership status. Most States require a sharing of profits for a partnership to exist. Some also require a sharing of losses. Most States generally give weight to the way the parties believe they are organized. Therefore, it may not be wise to use the term "partnership" in business transactions, discussions with others, or correspondence unless partnership status is desired.

The best procedure is to develop a written partnership agreement and to state clearly the provisions governing the arrangement. Unless otherwise specified in the agreement, all partners in a general partnership have an equal voice in managing the business and a majority vote governs. Limited partnerships, as discussed later, are an exception to this rule.

### Partnership Mechanics

Partnership accounting procedures define partnership interests in terms of capital, profits, and losses. A partner's capital interest is measured by his (her) capital account which reflects that person's economic stake in the partnership at any given time. Initial contributions are recorded and are increased to reflect income and decreased to reflect losses and distributions.

### Partnership Units

Family partnerships sometimes utilize partnership units to reflect ownership interests. These are similar to shares of stock and may be represented by paper certificates as is stock. The use of units on the partnership books rather than percentage adjustments makes gifts and sales of partnership interests to family members easier to accomplish. Such transactions can be made by simply transferring certificates.

### PARTNERSHIP ATTRIBUTES

Under State law a partnership is an entity that may acquire and convey title to property. When a partnership does own property, any partner (except in a limited partnership) may convey title on behalf of the partnership.

### Flexibility

As compared to corporations, partnerships are extremely flexible devices. The partnership agreement can easily be amended up until the time the partnership income tax return is filed in order to realize desired economic and tax consequences. This additional flexibility in structuring financial arrangements may lead, however, to a substantially more complex partnership agreement and increased scrutiny under the Federal income tax law.

*Contributions.*--Contributions of property may be made to a partnership without recognition of gain; in some cases, this is not possible with a corporation. The partnership adopts the partner's basis for property transferred to it, and the contributing

partner's capital account, in turn, adopts the basis of the transferred property.

*Withdrawals.*--The ability to withdraw property from a partnership without adverse tax consequences is a significant advantage. The distribution of property, other than cash, by a partnership to its partners normally is not subject to taxation. Instead, the partner receives the property with a carryover adjusted basis unless the distribution is being made in liquidation of a partner's interest. In that case, the adjusted basis of the property is determined with reference to the adjusted basis of the partner's partnership interest. Corporate distributions, on the other hand, are treated as dividend payments or, if made as liquidating distributions, as payments in exchange for stock. And finally, liquidation of a partnership is generally a nontaxable event. This is generally not the case with a corporate liquidation.

### **Unlimited Liability**

Probably the best known characteristic of a general partnership is the unlimited liability of all partners for obligations of the partnership. The partnership creditors must first make a claim against the partnership assets; they can then make a claim against the personal assets of the individual partners if any debt remains. Also, creditors of an individual partner can make a claim against the partnership assets up to the amount of that partner's interest. These rules do not apply to the limited partners in a limited partnership as discussed later.

### **Management Rights**

In a general partnership (as opposed to a limited partnership), all partners have equal rights in the management and conduct of the business. No one can become a member (partner) of the partnership without the consent of all of the members. Both these rules, however, are subject to any agreement to the contrary among the partners. Thus, while State corporate statutes establish specific requirements relating to voting rights, partnership statutes permit almost complete flexibility subject to the requirement that the partners all agree.

### **Partners as Agents**

Every partner in a general partnership is an agent of the partnership for purposes of its business, and

any action by a partner within the scope of business will bind the partnership. Partnership liability does not result, however, if the partner has no authority to bind the partnership and the party with whom the partner is dealing has knowledge of that fact.

### **Assignment of Partnership Interest**

A partner's assignment of interest in the partnership does not automatically entitle the assignee to participate in the business. Unless the assignee is accepted as a partner by agreement of all of the original partners, the assignee is merely entitled to receive a share of the partnership profits.

### **Partnership Termination**

A partnership may not have as much stability as the members might like. As with a sole proprietorship or joint ownership, a partnership is generally vulnerable to premature liquidation in the absence of prior planning. If there is a written partnership agreement, the term of existence can be stated. Usually, however, partnership agreements provide that the partnership exists at the will of the partners. Even though a term of existence may be specified, the courts do not generally force partnership continuation against the desire of a partner to withdraw. Dissolving partners have three choices: (1) liquidate, (2) form a new partnership, or (3) shift to a sole proprietorship or corporation.

On the death of a partner, the surviving partners are generally under a duty to wind up the business and make a distribution to the deceased partner's estate. But some courts have recognized the right of the surviving partners to bind the deceased partner's heirs to continue the business. When continuation is desired, steps should be taken to include a provision in the partnership agreement that requires continuation and that gives the executor of each partner the power to act as a partner.

## **ESTATE PLANNING WITH PARTNERSHIPS**

### **Minors as Partners**

Estate planning for members of a family partnership often involves transfer of partnership interests to minors. The intention may be to reduce the



Nevertheless, the limited partnership provides an ideal vehicle for excluding certain family members, such as minors and distant co-owners, from management control. A limited partnership may also be useful if one of the partners, such as a parent, wishes to withdraw from active participation in management of the tree farm. It permits the parent to leave capital invested without the fear of unlimited liability.

Unlike a general partnership, which requires no formal action other than agreement among the partners, a limited partnership must be formed in compliance with specific State law. This requires the execution of a certificate of limited partnership, which is placed on file with a public official, usually the county clerk.

**Example 16.1.** Mr. and Mrs. Brown together own a substantial tree farm and have decided to utilize the annual gift exclusion in conjunction with a limited family partnership in order to lower the value of the timberland for estate and gift tax purposes. This procedure will allow the Browns to gradually transfer ownership of the timberland to their children but yet permit them to continue managing the property and make all the operating decisions. To implement the plan, the Browns first execute a limited partnership agreement in accordance with the law of their State, with themselves as general partners and the children as limited partners. Concurrently with establishment of the partnership, ownership of the tree farm is transferred to the partnership, with Mr. and Mrs. Brown each having a partnership interest equal to 50 percent of the tree farm's value. Beginning that year, and each year thereafter, the Browns gift to their children an interest in the partnership equal to or less than the annual gift tax exclusion. The value of the gifts can be substantially discounted because-- for many years, at least--the Browns are giving their children minority interests in the partnership. Both Mr. and Mrs. Brown, or one of them, could be paid a salary or other compensation by the partnership for managing the tree farm from timber sale or other income received by the partnership. The Browns, as managing (general) partners, would determine how to distribute and/ or invest the cash received by the partnership.

