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CAAV National Tutorial 2024

Partnerships

These notes are provided by Michelmores LLP in order to assist CAAV Probationer candidates in their preparation for the CAAV Fellowship Exams. They are intended to provide candidates with sufficient knowledge of the topic to meet the requirements of the relevant area of the syllabus, and as such they are not intended to be a comprehensive guide to this area of law, or a substitute for legal advice. They do not set out the opinion of Michelmores LLP or its employees on any particular matter, and are not to be used for any purpose other than preparing for the CAAV Fellowship Exams.

Relevant Statutes

Partnership Act 1890 (the **PA 1890**)

Limited Partnerships Act 1907

Limited Partnerships Act 2000

Exam Scope

At the time of writing, this topic has not been covered in any detail in the National Papers. However, it is in the syllabus, and a question on it is not unlikely, as we move forward into using more diverse business structures in practice.

These notes are comprehensive.

It is suggested that appropriate areas to cover in exam preparation might be:

- What a partnership is and involves.
- Common heads of terms for a basic partnership agreement.
- The fact that the PA 1890 covers partnerships not reduced to writing (or which are incomplete).
- How interests in land are held by partnerships and their partners.
- What dissolution of a partnership involves.

Partnerships – The Basics

Almost all farming partnerships are structured as traditional partnerships, governed by the *Partnership Act 1890*. These are the focus of these detailed notes.

The following types of partnership are less common in an agricultural context, but you should be aware of their existence:

- Limited Liability Partnerships (LLPs) under the Limited Partnerships Act 2000; and
- Limited Partnerships, governed by the Limited Partnerships Act 1907 (similar to general, traditional partnerships, but one or more partners have limited liability).

Beyond knowing of their existence, and some limited differences between these types of partnership and the more common PA 1890 form, the characteristics of these types of partnership are beyond the scope of the exam.

PA 1890

The Basics

Regardless of how they are constituted under PA 1890, traditional partnerships do not constitute a separate legal entity: '*the relationship which subsists between persons who carry on a business in common with a view of profit*': section 1, PA 1890.

Liability is unlimited: partners are jointly and equally liable for the debts and 'wrongs' of the partnership: sections 9, 10, 24 PA 1890.

The PA 1890 provides a default, fall-back position if the documents are silent on a particular point or if there is no Partnership Agreement.

The Starting Point

The starting point is always – **is there a written Partnership Agreement**?

If so, first look at the Partnership Agreement and any supplemental agreements, memoranda and minutes. It is important to establish who the partners in the partnership are (whether individuals or corporate entities).

The PA 1890 will apply subject to any agreement between the partners to the contrary. The PA 1890 therefore allows the partners to vary their mutual rights and duties – either by express agreement or implied consent evidenced through 'a course of dealing' (section 19, PA 1890).

Note that a 'course of dealing' may be evidenced by the signing of the annual accounts by the partners. This is why the Accounts are so important – often the only written evidence available.

Express agreement should ideally be in advance via a well written partnership agreement but can obviously be at any time - e.g. at point of restructure. There is a risk is that sensible compromises/agreements cannot be reached at a later point, and default PA 1890 provisions are then imposed.

Common Issues

The most common problems with partnerships are:

- No written partnership agreement at all;
- Poorly drafted agreement;
- Outdated agreements; and
- Accounts prepared on basis which does not reflect Partnership agreement or Partner's intentions.

Most farming partnerships operate without a written agreement or with an agreement which is old or outdated and no longer reflects the business structure or the annual accounts.

This can lead to uncertainty, disputes, and / or the imposition of inappropriate default provisions under PA 1890.

Partnerships need properly drafted partnership agreements.

The Default Terms

If there is no agreement to the contrary, the following default provisions under PA 1890 are imposed:

- The death or bankruptcy of a partner will trigger a dissolution (whether the partnership was for a fixed term or at will): section 33
- Partnerships at will are also dissolved on the retirement of a partner: section 26 or upon service of notice to dissolve: section 33(c)
- There is no power to expel a partner: section 25
- The partners are entitled to share equally in the capital and profits of the business and must all contribute equally towards losses (capital and income): section 24.
- Every partner may take part in the management of the partnership business: section 24

Each of these default terms may be varied by agreement.

Varying the Terms

Farming partnerships will usually consider the following variations from the default provisions:

- Whether the partnership is to continue following the death, retirement or expulsion of a partner (provided there are two or more surviving/continuing partners).
- The inclusion of expulsion provisions in event of a partner's bankruptcy, or if a partner starts to act in manner prejudicial to the farming business.
- To allow for unequal profit sharing
- The continuance of business following an 'exit' event: you will commonly see partners granted an option, on death or retirement, to purchase the outgoing partner's share in the partnership – allowing them to continue the business.

Continuance/Term

A partnership may be entered into for:

- a fixed term
- for joint lives
- for the purpose of a single 'adventure or undertaking' or,
- for an undefined time (a **partnership at will**).

Partnerships at will continue for so long as all of the partners wish it.

Under PA 1890 a partnership at will can be terminated at any time by **any** partner serving notice to dissolve the partnership: *section 32, PA 1890*.

End of a Partnership – Dissolution

Dissolution arises when the existing partnership comes to an end. There are two types of dissolution:

- Technical dissolution: when a legal dissolution is triggered by a particular event (e.g. death of a partner) but the remaining partners in practice carry on a new partnership immediately afterwards using the assets and capital of previous business.

- General dissolution: a final winding up of the business, whereby the debts and liabilities are settled, assets are sold off and the business brought to an end.

After dissolution, the partners have continuing authority to bind the firm so far as may be necessary to wind up the affairs of the partnership: section 38.

Section 42 PA 1890 makes provision for an outgoing partner (or their estate) to share profits made from the partnership capital/assets after dissolution, but before final settlement of accounts between the partners which may be attributable to their share of the partnership assets, or interest at 5% per annum on the amount of their share of the partnership assets.

The distribution of assets on dissolution is governed by section 44 PA 1890:

- Losses, including losses and any deficiencies of capital, are paid first out of profits, next out of capital and lastly, if necessary, by the partners individually in the proportion in which they were entitled to share profits

- The partnership assets are sold, and the net proceeds applied in the following order:

  - 3rd party creditors are paid out;

  - Partner loans and current accounts are paid out;

  - Partnership capital is paid out rateably in accordance with the partners' capital accounts;

  - The residue (if any) is divided among the partners in the proportion in which profits are divisible.

Death of a Partner

On the death of a partner, the surviving or continuing partners have no inherent right to acquire the deceased or outgoing partner's share.

Unless otherwise agreed, the default provision is that the partnership must be wound up under section 44 and the assets sold.

The outgoing partner's entitlement to capital is frozen and becomes an entitlement to a fixed sum of money: PA 1890, s43.

The key points relating to the death of a partner are:

- A Partnership Agreement will take precedence over any wills, so it is important to understand what it says / what rights partners have in relation to their partnership shares.

- The bequest of 'partnership share' in a will does not, of itself, entitle beneficiary to become a partner in the business. That can only happen by agreement of all the partners (continuing and incoming) at the relevant time: PA 1890 s.24(7).

- In a farming family scenario, if the parents wish to leave some of their assets to non-farming sibling or spouse, this needs careful thought. Often the bulk or all of the parent's assets are tied up in the partnership business; **and** there may be no wish for that sibling/spouse to become involved in the farming business moving forward.

- Partners may opt to include a mechanism in the partnership agreement which is an 'option to purchase'. If the deceased partner's share in the partnership is not left to a continuing partner, the continuing partners hold a right under the partnership agreement to exercise an 'option' to purchase the share of the deceased partner.

- Alternatively, if it is important for a partner's share to devolve to a specific individual, one option is to include a 'nomination' clause or 'permitted assignee' provision. Under this clause, the partners are given express ability to bequeath or transfer their shares to that individual and it is pre-agreed that the individual can become a partner in business.

- Consideration must be given to how assets are held by the partners. Whether partnership property or separate property (see below). If land or assets are partnership property, they cannot be bequeathed under that partners will.

Land Assets

It is very common for partnerships to include land as partnership property. In that situation, the partnership is not a simple trading entity but a vehicle which regulates the ownership of significant assets and wealth between the partners.

Assets are often shown on the balance sheet at their 'historic cost' (e.g. acquisition/base cost). This can lead to unintended but substantial shifts in the ownership of the assets over a period of time by virtue of the 'revaluation surplus', if the partnership agreement does not make adequate provision.

Partnership Property

There is an important legal distinction between 'partnership property' and 'separate property'.

Partnership Property *are* assets that are owned by the business. This will be reflected on the balance sheet.

Capital profits and losses arising from partnership property belong to the partnership. On dissolution, partnership property can be required to be sold to pay the debts and liabilities of the firm: *section 39, PA 1890.*

Section 20(1): All property brought into the partnership stock or acquired on account of the firm, or for the purposes and in the course of the partnership business, is ***partnership property*** *and must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement.*

Section 20(2): The legal estate or interest in any land which belongs to the partnership shall devolve in trust for the persons beneficially interested in the land

Section 21: Unless the contrary intention appears, property bought with money belonging to the firm is deemed to have been bought on account of the firm.

Separate Property belongs to one or more partners *outside the firm* but is nonetheless used by the business.

E.g. Land: off balance-sheet but occupied and used by the partnership.

Whether assets are partnership property or not has significance in terms of the ownership and taxation position.

Assets are often introduced onto the balance sheet for tax reasons or for bank financing, but accountants (and Partners) may not appreciate the legal effect of the changes they make within the accounts to the underlying ownership of asset.

There should be 'land capital accounts' that clearly allocate the value of the land owned to each of the partners separately. If land is introduced by one of the partners for the partnership to farm but retains the beneficial interest, the value of that land should be solely attributed to that partner.

Land as Partnership Property

Following the introduction of land into the partnership, the **beneficial ownership** of that land changes. It is no longer owned by the original landowning partner(s). Henceforth the land is held on trust for the members of the wider partnership – they become the beneficial owners.

Accordingly, the legal nature of the asset changes once it becomes partnership property from the point of view of the original 'landowning partner'. Beforehand, that partner held an interest in land. After it has been introduced as partnership property, the landowning partner no longer owns the land directly, but instead **owns an interest in the capital of the partnership** which corresponds to it.

It is not necessary to transfer the legal title into the names of all the partners. The distinction between the legal and beneficial ownership of land means that the legal owners (e.g. the original landowning partner(s)) will simply hold the land on trust for the partnership. An appropriate declaration of trust needs to be made to confirm that. The declaration needs to be in writing and by deed. This is often included within a Partnership Agreement.

The registered title for the land should be updated to include a restriction notifying third parties that the land is held on trust and that a trust of land exists. The partners should also consider appointing a second legal owner to the title, if the land is registered in the name of a single partner.

If land is partnership property and is on the balance sheet, it can be held either as:

- part of the general capital, or
- allocated to separate land capital accounts.

The use of land capital accounts is best practice. This ensures that the capital value of the land is allocated only to those partners who have specified land capital accounts, and only those partners will have an interest in the land capital comprised within the partnership. This is often important for tax reasons, to ensure 'land capital' is ringfenced to the Partners who introduced it.

Practical Points:

- The Partnership Agreement / documentation needs to confirm who is entitled to the land capital accounts **and** to the profits and losses attributable to the land concerned.

- Always record and identify the properties carefully – preferably by a detailed schedule in the Partnership Agreement with reference to plans and HMLR title numbers.

Withdrawal of land from a Partnership:

- Once on the balance sheet, the partner(s) only have an interest in the capital, not the land itself. They will lose direct control of asset.

- The partners cannot withdraw capital during the continuance of the partnership without consent of all partners **unless** they are granted the right to do so by partnership agreement.

However, partners holding a land capital interest may want to be able to recover the land itself, rather than just its value, e.g. on death, retirement, for development, or on the solvent winding up of the partnership. They will need to include express provisions to facilitate the withdrawal of land within the Partnership Agreement. However, the parties will need to consider the impact on the continuing partners. If significant land is extracted on death or retirement, will the business remain viable? Points to consider include: notice periods, options to purchase (at market value), or winding up in the alternative.

Note also, that in an insolvent winding up, the land will be used to meet the liabilities of the partnership. In this case, the original 'landowning' partner may want to retain the right to buy the land back.

Land as Separate Property – Tenancies and Licences

The landowning partner allows the partnership to farm the land, often via an informal licence arrangement or via a tenancy.

Licences: Provides max flexibility and control for landowning partner.

Tenancies: Granting an FBT can be useful if a non-partner has an interest in the land or if the Partnership wants security for a fixed term.

Partners will need to consider SDLT liability (depending on rent and term).

Consider:

- Responsibility and liability for repairs, maintenance and insurance

- Payment of outgoings

- Treatment of alterations and improvements

Also consider IHT consequences of either option - APR available at 100% if

- land is let under an FBT: s116(2)(c) Inheritance Tax Act 1984 **or**

- the landowner has right to vacant possession of the land or the right to acquire VP within next 12 months: s116(2)(a)

Improvements to Land

What is the correct approach when the partnership pays for improvements to land and buildings that are held as separate property, outside the partnership or to land that is held on land capital accounts by specific partners?

The partners need to agree the treatment of these improvements and the value they confer – record it in formal a memorandum and consider the accounting position.

The position is straightforward if land was purchased by the partnership and forms part of the general capital or if the partners hold equal shares in the land capital – all the partners have share in the capital value and in the expenditure. However, often older generations hold more land capital than younger generations, and this imbalance should be considered.

Consider Tax

It is common to see land being held as partnership property, for inheritance tax (**IHT**) purposes.

Part of any succession plan is the tax efficient transfer of assets to the next generation. Agricultural Property Relief (**APR**) will usually be available at 100% on farmland, whether it is held as partnership property or outside the business. However, note that APR will only relieve the *agricultural value* of an asset.

Business relief (BR) has scope to relieve the full market value. BR reduces the value of a business and its assets. BR is available at 50% if property is *used in a business* but the relief increases to 100% in respect of **interests in a business.** Once an asset is 'partnership property', it becomes an 'interest in a business' potentially qualifying for 100% BR.

BR is becoming an increasingly important relief in the context of development land / hope value; diversified enterprises; larger estates with mix of enterprises and income (*Balfour structures* with some 'investment' income sheltered within a predominantly trading vehicle*)*

Taxation on re-structures: Consider tax implications when assets are moved in or out of partnership: CGT, SDLT and IHT. Reliefs e.g. holdover may be available depending on circumstances and if structured properly. **Partners need to obtain specialist tax advice in advance.**

Partnership Capital

The law regards partnership capital as a fixed amount expressed in cash terms.

On commencement, the partners introduce capital to the business which remains fixed on the balance sheet. It is **not** the same as:

- Loans from the partners
- Undrawn profits

Capital Accounts: reflect the capital each partner has introduced.

It is good practice to split the different types of partnership capital within the accounts:

- *General capital:* credited to general capital accounts – e.g. kit and machinery; herd/livestock;

- *Land / property capital:* created on the introduction of land to the partnership by one or more of the partners. This should be credited to the relevant partners in separate land capital accounts. Improvements to property.

Capital profits and losses accrue to the capital accounts. These arise when the value of the capital assets goes up and down. They are not usually shown in the annual accounts, unless the book value of assets is updated (re-valued) on the balance sheet. Revaluation of capital assets is uncommon. So, capital assets usually appear in the annual accounts at a significant undervalue (known as *the revaluation surplus).*

Current Accounts: represent each partner's **income profits (or losses)** less drawings – which arise from normal trading activities of the partnership

Unless there is anything to the contrary within the Partnership agreement, the partners can withdraw the balance on their current account (i.e. take cash drawings).

Income Profits v Capital Profits

It is important to distinguish between the income profits and capital profits (via separate **current account** and **capital account(s)**)**.** Otherwise, the underlying capital assets and the ownership ratios are mixed with the day to day trading profits and losses. It can then be difficult to determine whether a partner has capital in the partnership or any undrawn profits.

Profit Sharing Ratios:

The Partnership Agreement needs to clearly distinguish between income and capital profit sharing ratios. Otherwise, the same ratio will apply to both income and capital profits (pursuant to *section 24(1) PA 1890*).

A distinction is required because the senior partners usually hold significantly more of the capital in the partnership and will likely want to ensure the associated capital profits accrue to them.

Income profits (and losses):

The percentage split often reflects the level of involvement in the day to day work and management of the farm, so you can usually see shifts over time as the Partners' responsibilities and involvement change.

It is often agreed that there will be a preferential 'first charge' / draw on income by the managing partner(s), with residual income profits then split between the remaining partners on an agreed percentage basis.

Partnership Agreements very often contain an express provision allowing the Partners to agree new profit-sharing ratios – to allow flexibility (usually for tax reasons). This can then be evidenced through the annual accounts, although it is best practice to do so by a written Memorandum of Agreement as well.

The Partnership Agreement needs to be clear that any changes in income profit sharing ratios are limited to the income profits – so that capital profit sharing ratios remain unchanged.

Capital profits:

The standard declaration is that the capital profits shall be allocated to the partners 'for the time being entitled to capital and in the proportions in which they are so entitled' **or** 'in the proportions to which the balance of each of their capital accounts bears to the total of all their capital accounts'

The allocation of capital profits and losses then reflects the contributing partners' underlying contributions – which will change over time as more capital is invested and more assets are acquired.

Interaction with Succession Planning

A key theme throughout these detailed notes is the importance of the Partnership Agreement and the business structures dovetailing with the farming family's succession planning.

In the context of family partnerships, the farming members of the family often rely on inheriting the partnership interests and land from their parents. How can that be achieved in practice? How are non-farming family members provided for? What are the taxation consequences? Have the family ever spoken about it?

The key requirement is to ensure that everything ties in together – the provisions within the Partnership Agreement dealing with arrangements on death, need to reflect the wills of the Partners and any trusts.

- On the death or retirement of a Partner, the outgoing Partner's entitlement to capital is frozen and becomes an entitlement to a fixed sum of money: PA 1890, s43.

- the surviving or continuing Partners have no inherent right to acquire the outgoing Partner's share in the business under PA 1890. The default provision under PA 1890 is that death or retirement cause the Partnership's dissolution, meaning the partnership must be wound up under section 44 and the assets sold. Everyone gets their capital out of the business in that way.

So, if the Partners have a written partnership agreement and have varied that default provision, and the partnership won't terminate on death/retirement (whilst at least 2 partners wish to continue), there needs to be a mechanism for the devolution of the outgoing partners share OR a mechanism so they can extract their capital from the business.

If no such mechanism is included, the outgoing partner's share is 'locked into' the business, and they are entitled only to receive a share of profits attributable to their share in the partnership capital, with no corresponding right to be involved in the business or control over decisions/assets.

Please see the notes on 'Death of a Partner' above, for more detail on provisions with the Partnership Agreement to allow the partnership share of a deceased Partner to devolve as desired on their death.