Wilsons

Farm Partnerships – Practice Notes

A series of eight practice notes for Practical Law written by

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Practice Note 1. – Basic Principles

The series comprises:

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2. Who owns the business and assets?
3. Dissolution and winding up – retirement and death
4. How land can be owned and occupied in a partnership situation
5. Running the Partnership
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Farm partnerships: basic principles

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A note forming part of a series on farming partnerships. This note looks at the basic principles to consider when setting up a farm partnership, such as how the farming property and capital will be held. It looks at the differences between income and capital profits, the need to hold separate capital accounts and the need for consistency between partnership documents and accounts.

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Scope of this note

Partnership arrangements are more complicated than they first appear, particularly where significant capital assets are involved. There is not always much help in terms of published materials. Most published works relating to partnerships are directed towards professional service businesses or trading businesses.

Farm partnerships often involve the ownership of valuable assets, and have to deal with issues of land ownership and succession to a family business. These raise very different questions.

This note deals with English law partnerships only. Under English law there are three types of partnerships:

- Traditional partnerships, governed by the Partnership Act 1890 (PA 1890) (see *Practice note, A toolkit for partnerships (www.practicallaw.com/3-518-3601)*).

- Limited Partnerships, governed by the Limited Partnerships Act 1907 (see *Practice note, Limited partnerships under the Limited Partnerships Act 1907 (www.practicallaw.com/6-519-5834)*).
- Limited Liability Partnerships (LLPs), governed by the Limited Liability Partnerships Act 2000 (see *Practice note, Limited liability partnerships: materials (www.practicallaw.com/5-107-3903)*).

Almost all farm partnerships fall into the first category, although increasingly we are seeing more of the other two. This note deals principally with traditional partnerships (limited partnerships are very similar, but with one or more partners having limited liability). LLPs operate under a completely different set of legal rules, although they are treated in a similar manner for most tax purposes.

Advising farming partnerships

Difficulties in advising farming partnerships arise for a number of reasons. These issues have manifested themselves, over the years, in many disputes that have ended up in court, usually to the detriment of all concerned. Often these have arisen because of a lack of clear advice given to the parties in the past.

A recent example was *Ham v Ham and another [2013] EWCA Civ 1301*. This case concerned the interpretation of a farm partnership agreement, in particular, the meaning of the valuation provisions under which an outgoing partner's interest should be acquired. Lord Justice Briggs had this to say to those who advise farming partnerships:

> "... it is unfortunate that a matter of such importance should have to turn on an anxious and difficult consideration of factors pointing in different directions, in a context where it has throughout been common ground between counsel that the answer is by no means clear, and where reasonable minds have reached different conclusions. It is unhappily common for this type of issue not to be clearly dealt with in partnership agreements. It is an obvious problem in relation to farming partnerships, where the land forms an asset of the firm. It is to be hoped that, in future, those preparing such agreements will take note of the anxiety, expense and delay which such unnecessary uncertainty can cause."

It is very important for professional advisers to understand the issues fully, both in terms of partnership law and accounting practice. The professionals need to work together. The accountants, solicitors and land agents should all have a grasp of the partnership agreement and the accounts, and how they work together.

The following common issues arise in farm partnership agreements.

Significant assets and liabilities involved

It is increasingly common, for tax planning reasons, for farming partnerships to include land as partnership property. As a result, a partnership agreement no longer deals only with trading activities, but regulates the ownership of significant assets between the partners. In the case of a farming family, this may involve the bulk of their wealth. This means it is an important document that requires careful consideration.

The values of the assets may be considerably greater than those shown on the balance sheet, and this can lead to unintended but substantial shifts in the ownership of the revaluation surplus (see *Income and capital profits*) over a period of time.

Difficult technical areas

There is a lot of misunderstanding among professional advisers. One reason is that partnership practice is a matter of both law and accountancy. When faced with difficult technical areas, it is often a matter of going back to basics and analysing the position from the ground up. In the area of farming partnerships, this is particularly important both in terms of partnership law and tax.

The need to plan beyond the current position

The following are examples of what need to be addressed:

- What happens in the event of a partner's retirement, incapacity or death?
- Will the partnership continue in the event of one partner's retirement, incapacity or death?
- How will the former partner's interest be valued should something happen?
- How will the former partner be paid out?
- What would happen in the event of a dispute?

More often than not these issues are left in the "too difficult" category.

Partnership documents and the course of dealing

With a traditional partnership, the PA 1890 applies, although (in large part) subject to whatever the partners may agree to the contrary. The partners can vary their mutual rights and duties (ascertained by agreement or defined by the Act) by express consent or consent implied through a course of dealing (*section 19, PA 1890*). It is therefore the fallback position if they do not record anything or the documents are silent on a particular point.

The partnership documents include the partnership agreement and any supplemental agreements, memoranda and minutes.

A "course of dealing" may be evidenced by signing the annual accounts. This is why the accounts are so important, as they can override what has been agreed and, over the years, can greatly change the position between the partners.

If nothing is recorded and there is no evidence of anything to the contrary, the starting point is that the partners are entitled to share equally in the capital and profits of the business (*section 24(1), PA 1890*). The question of who owns the capital profits would fall to be determined on the basis of what happened in a winding up, in accordance with the rules for distribution on final settlement of accounts (*section 44, PA 1890*).

Property held inside or outside the partnership

Partnership law makes a clear distinction between "partnership property" and "separate property".

Partnership property is essentially that which is owned by the business and reflected on the balance sheet. In the absence of agreement, the rules as to what is and is not partnership property are quite complicated so it is important that this is set out clearly in the partnership documents. The capital profits and losses arising from partnership property will belong to the partnership. In a dissolution, the partnership property can be required to be sold to pay the debts and liabilities of the firm (*section 39, PA 1890*).

Separate property (as distinct from partnership property) belongs to one or more of the partners outside the firm, but is used by the business. In a farming partnership, land may be held by one or more partners outside the balance sheet, but be occupied and used by the partnership. The statutory regimes for the different taxes (particularly stamp duty land tax) can have a different approach to what is partnership property. *HMRC: Business Income Manual (BIM): 82058* provides useful notes on the subject, and confirms that partnership law is the starting point (*section 20, PA 1890*).

Partnership capital

It is in the area of partnership capital where legal theory and accounting practice tend to diverge. Nonetheless, partnership arrangements fall to be tested against the law, so it is important that the legal principles are followed. This frequently comes into focus in the context of partnership disputes or when seeking to analyse partnership arrangements for tax purposes.

The law regards partnership capital as a fixed amount expressed in cash terms. Partnership capital is analogous to share capital in a company. On commencement, the partners bring in capital which remains fixed in the balance sheet and cannot be withdrawn without the consent of all the partners. Partnership capital must be distinguished from the underlying partnership assets, in the same way as a company's share capital is distinguished from the assets owned by the company.

Partnership capital should be distinguished in the accounts from the following:

- Loans from the partners. These should appear on the balance sheet as loans.
- Undrawn profits. These should appear in a partner's current account.

Types of capital

It is possible to create different sorts of partnership capital, in just the same way as different varieties of shares can be created in companies.

The normal type of capital contributed by the partners is usually termed "general capital". This is credited to the partners' general capital accounts.

In the context of farming partnerships, "land capital" is often used to refer to the partnership capital created on the introduction of land by the partners. When one or more partners introduce land, the partnership capital representing it is credited to their land capital account.

It is possible to create further classes of capital, such as "accumulated capital" or "retained capital" in order to introduce further capital or capitalise profits without affecting the balance of general capital held between the partners.

To avoid confusion, it is best to avoid using terminology that is commonly used within accounting practice, such as "working capital" or "fixed capital". These terms have particular meanings for accounting purposes, and it is dangerous to use them in a different context.

Income and capital profits

It is important to understand the difference between income profits and capital profits. Income profits and losses arise from the normal trading activities and are shown in the profit and loss (P&L) account. Capital profits and losses arise when the value of the capital assets goes up and down. These will only be reflected in the accounts if the book value of assets is updated (that is, the assets are revalued on the balance sheet).

There are some areas of crossover between income and capital profits. For example, the increase or decrease in the value of trading stock will appear on the P&L account. Depreciation (that is, the writing down of fixed assets) will be charged to the P&L account. These matters are dealt with in accordance with standard accounting practice.

Farming partnerships frequently involve assets that (for tax reasons) are not revalued on the balance sheet, and hence may appear in the accounts at a significant undervalue. The element of undervalue is known as the "revaluation surplus". This may be true of the following:

- Freehold land.
- Quota and entitlements.
- Dairy herds on the Herd Basis.

The partnership agreement should clearly distinguish between income and capital profit sharing ratios. If it does not, and simply provides for a single profit sharing ratio, this will (on the face of it) apply to both income and capital profits. Worse still, if it is an old agreement and the profit sharing arrangements have changed over the years in the accounts, these later ratios are likely to prevail. This can significantly change the entitlement to the revaluation surplus.

Each element of profits and losses would normally be divided under the partnership agreement along the following lines:

Type of profits and losses	**Divided in accordance with**
Income profits and losses	Income profit sharing ratios
Capital profits and losses on general assets	Proportions in which general capital held
Capital profits and losses on land capital	Proportions in which land capital held

Keeping separate capital and current accounts

The accounting treatment of capital on partnership balance sheets is surprisingly diverse, and this largely stems from a failure to draw a clear distinction between partnership capital, loans, and undrawn profits. Both the accounting treatment and the terminology vary considerably.

A common practice is to combine capital and current accounts on the balance sheet (as rolling capital accounts). This should be avoided. *Roderick I'Anson Banks, Lindley & Banks on Partnership (Sweet & Maxwell, 19th ed, 2013)* refers to this practice as "accounting heresy". In a company, it would be like mixing the share capital and undistributed profits together on the balance sheet, so that the ultimate ownership could not be determined. It has a similar effect in partnerships.

Overdrawn current accounts

Unless anything to the contrary appears in the partnership agreement, a partner may withdraw the balance on his current account. However, the agreement will usually provide that drawings can only be made in line with an agreed policy, and that any deficit should be repaid.

A significantly overdrawn current account indicates that something has gone wrong somewhere, for example, a history of losses or of extracting more cash than the profits allow.

The following are some important consequences of an overdrawn current account:

- Restriction of interest relief. If there are partnership borrowings, interest relief may be restricted where there is an overdrawn current account. This is because the partnership has ostensibly borrowed to fund the overdrawn amount.
- ***Reservation of benefit (www.practicallaw.com/9-382-5631)*** for inheritance tax purposes. As an example, where a father and son are in partnership and the father has, since 1986, given an interest in the partnership to the son, an overdrawn current account for the father would possibly create a reservation of benefit over the interest given. That is because the father is under a duty to repay a current account deficit and is effectively receiving an interest free loan from the partnership.
- Loans to participators after 20 March 2013. In the case of a mixed partnership, corporation tax can arise.
- Disguised remuneration. In the case of a partner who was, is or will be employed by the corporate member of a mixed partnership, the disguised remuneration rules could potentially apply.

Aligning the partnership documents and the accounts

It is common to find that the partnership documents and the balance sheet are inconsistent, and the parties need to work together to analyse the position correctly and ensure that it is properly reflected.

The balance sheet of a partnership, in the annual accounts, will summarise the assets and liabilities, and will reflect how they are owned as between the partners. Strictly speaking, each partner should have a capital account (reflecting the capital he has introduced) and a current account (which represents his income profits, less drawings).

If land capital accounts are used, it is very important that they are shown correctly on the balance sheet. It is therefore important that the partnership accountants are fully aware of the arrangements.

Sample balance sheet

An example of a balance sheet for a farm partnership with land capital accounts, with notes showing the analysis of separate current and capital accounts:

Balance Sheet

Fixed Assets

Tangible fixed assets		x	
Investments		x	
			x
Current Assets			
Trade debtors		x	
VAT repayable		x	
Prepayments		x	
Cash at bank		x	
			x
Creditors			(x)
Net Assets			x
Represented by			
Current accounts	(Note 1)	x	
Capital accounts	(Note 2)	x	
			x

Note 1 - Current Accounts

	Partner A	Partner B	Partner C
Brought forward	x	x	x
Add: Profit share	x	x	x
Less: Drawings	(x)	(x)	(x)
Carried forward	x	x	x

Note 2 - Capital Accounts

	Partner A	Partner B	Partner C
General Capital Accounts	x	x	x

Land Capital Accounts

Land Capital Account No 1	x		
Land Capital Account No 2		x	x
	x	x	x

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This resource is maintained, meaning that we monitor developments on a regular basis and update it as soon as possible.

Resource history

Changes made to this resource
We will record here any changes to this resource as a result of developments in the law or practice.

Related content

Topics

Farm partnerships and farming agreements (http://uk.practicallaw.com/topic9-607-6428)

Practice note

Farm partnerships: how land can be owned and occupied in a partnership situation (http://uk.practicallaw.comtopic8-614-4526)

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