Montana Law Review

Volume 42
Issue 2 *Summer 1981*

Article 3

July 1981

An Overview of Partnerships: An Alternative to Traditional Planning

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Recommended Citation
Bradley E. Dugdale, *An Overview of Partnerships: An Alternative to Traditional Planning*, 42 Mont. L. Rev. (1981).
Available at: https://scholarship.law.umt.edu/mlr/vol42/iss2/3

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AN OVERVIEW OF PARTNERSHIPS: AN ALTERNATIVE TO TRADITIONAL PLANNING

Bradley E. Dugdale*

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I. Introduction

Business and tax planners strive to obtain the best tax results and, at the same time, accomplish the family goals of the client. Inflation causes everyone to explore all available avenues of stopping the growth in the estate of the older generation. The most common planning methods used have been corporate capitalization and recapitalization, the installment sale, and the private annuity.

Partnerships were sometimes used for very small business interests. With the advent of higher taxes, limited partnership tax shelters became the most popular entity to accomplish the goal of providing an investor with limited liability as well as write-offs many times greater than the out-of-pocket cash invested. From the more frequent use of the partnership came the revelation that as an entity the partnership provided unique planning opportunities as well as flexibility.

The purpose of this article is to present the strengths and weaknesses of traditional planning methods as compared to those of the partnership and limited partnership. There is no single planning tool that fits all circumstances. It is submitted, however, that the partnership and the limited partnership have their places in a wide variety of situations.[1]

II. Corporations

In Montana the corporation is the most popular business entity used in estate planning. In most commercial ventures this is due to the corporate features of limited liability and inventory build up at a lower after-tax cost. Until recently, the corporation has also been the leading entity used in farm, ranch and business estate planning. Most tax planners are comfortable with the use of the corporate vehicle for business planning because it has been with us more than half a century and case law and statutory structure have established the legal and tax rules.

1. Please read this article with the understanding that the writer's legal experience since 1965 has primarily involved farm and ranch business planning. Many of the comments were made in that context.

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A. *Advantages of Incorporation*

1. *Equity Ownership Transfer*

Families can transfer equity ownership through the use of non-voting stock, causing a reduction in death taxes even though the elder members of the family retain voting control in a separate class of voting stock. It is very difficult for businessmen or farmers to transfer part of the business to younger family members without losing control of specific assets. Transfering corporate shares eliminates the necessity of splitting business assets. The business can continue to operate as it has previously.

2. *Discounts*

When a farmer[2] dies owning real estate, machinery, grain, cattle, or similar assets the Internal Revenue Service (IRS) uses comparative sales to value the estate. Discounts from fair market value are seldom allowed, except, perhaps for fractional interests. Research revealed that corporate shares are valued at less than the fair market value of the underlying corporate assets. Valuation discounts can reduce the marginal tax rate dramatically, and in some instances, results in no tax at all.

As an illustration, if the sole asset in an estate is stock in a corporation and farm land of the corporation is worth $300,000, a 40 percent discount provides a taxable estate of $160,000. There will be no federal estate tax because the unified credit exempts estates under $175,625. By comparison, a sole proprietor would pay federal estate tax of $37,200.

As a general rule, discounts have been allowed for both gift and estate purposes. In one instance, a 66 percent discount was authorized.[3] The current position of the IRS, however, is to disallow discounts between family members.[4]

3. *Lower Tax Rates*

A corporation is a separate tax paying entity. Inventory and land can only be acquired with after-tax dollars. The marginal tax rates for a corporation are frequently much lower than those of a sole proprietor. The unincorporated farmer must sell sufficient products to (1) pay operating expenses, (2) pay interest on borrowed money, (3) support the family, (4) pay social security tax,

2. "Farmer" will be used to refer to both farmer and rancher.
3. Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D. Conn. 1954).
4. Ltr. Rul. 8010017.

(5) make principal reductions on debt, and (6) pay income tax. Since groceries, social security tax, income tax and principal reductions on debt are not legitimate tax deductions, the combined marginal tax rates can easily reach 50 percent or more.[5]

The tax tables for both individuals and corporations have graduated rates. The higher the income earned, the higher the marginal rates. A substantial reduction in marginal rates can be achieved if a portion of income is taxed to the corporation with the balance taxed to the individual.[6]

An individual with a 50 percent marginal rate purchasing $500,000 worth of land must have before-tax earnings of $1,000,000 to be able to pay taxes and still have enough left to make the principal payments due on the land contract. By comparison, a corporation that purchases $500,000 worth of land can in all likelihood do so at a marginal rate of 23-¾ percent (17 percent federal and 6-¾ percent Montana). The before-tax income required would be $657,737. It can be seen that the net land cost to the incorporated farmer is only two-thirds that of a sole proprietor. When added to the deductibility of living expenses, this fact readily illustrates the advantages of incorporating.

4. *Deductibility of Living Expenses*

A farming corporation can furnish living quarters for its employees and their dependents without each employee having to report that value for income tax purposes.[7] In addition, the corpora-

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5. Self-employment tax is currently 8.1%; federal income tax ranges from 14% to 70% and Montana income tax ranges from 2% to 11% plus a 10% surtax. The marginal tax rate frequently exceeds 60%. Note that although self-employment tax is not deductible, social security tax paid with respect to employees is deductible.

6. In 1980 if a family needed $15,000 for living expenses, $2,097.90 for self-employment tax and $10,000 for principal debt payment, the marginal rate would be as follows:

	Marginal Rate	Amount of Tax
Federal income tax	32.0%	$5,500.00
Montana income tax	10.0%	1,350.00
Self-employment tax	8.1%	2,097.80
	50.1%	$8,947.80

An incorporated farmer, taking only $5,000 in salary, would pay no income tax, and the total social security tax would equal $68.50 at the corporate level. The living expenses would be deductible so the corporation would pay tax on only $5,000. The corporate tax would amount to $850 for federal and $325 for state. Total tax savings would exceed $7,700.

7. I.R.C. § 119. For the employee to be able to exclude meals and lodging from his wages, he must live on the corporate premises. Unless otherwise specified, references are to the Internal Revenue Code of 1954, as amended.

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tion can take depreciation on the residence as a business expense.[8] The economic significance of a corporation rather than an employee owning the home is substantial. In order to build a $50,000 home an employee with a 50 percent marginal tax rate would require $100,000 before-tax income because an individual cannot depreciate a personal residence as a corporation can. To build the same home a corporation needs $50,000 in before-tax income because the corporation will eventually write off the entire home as business expense through depreciation deductions.

Meals, utilities, home insurance and maintenance are also legitimate business expenses to a corporation. Section 119 now provides that meals and lodging furnished to an employee's spouse and dependents are also excluded from gross income. To qualify, the lodging must be physically located on the business premises and must be furnished for the convenience of the employer. The employee also must be required to accept the lodging as a condition of employment.[9]

5. *Summary*

Typically, a corporation is an attractive device to (1) reduce substantial debt; (2) take advantage of section 119 and deduct living expenses which other taxpayers pay with after-tax dollars; (3) limit liability. Limited liability, however, is not a major consideration for the average farmer.

B. *Problems With the Corporate Entity*

1. *In-kind Split-ups*

Corporations have some problem areas. One of the most important elements involving the choice of business entity is not its formation, but its ultimate split-up. A farmer should not transfer land to a corporation if the likelihood of the corporation lasting 20-25 years is very slight or if the corporation is merely a device intended for short-term income tax savings. For example, where corporate lands are to be divided in-kind between family members, the corporation is probably not the best device to reach that result. The corporation could be liquidated under section 333. Section 333 is frequently considered but seldom used by tax planners primarily due to tax traps and unanswered questions.[10]

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8. I.R.C. § 167.
9. I.R.C. § 119(a)(1) and (2).
10. I.R.C. § 333(e)(1) seems to require that the corporation be placed on the accrual basis for purposes of determining earnings and profits. Earnings and profits are treated as

Another possibility would be a land exchange for stock under section 331 with the individual shareholders paying the capital gains tax on receipt of the property. This is probably unsatisfactory as the gain would occur in a single year and likely result in substantial tax.

A solution may lie in the use of section 355 which physically divides the corporate assets into two or more separate business entities. This works when active businesses will be carried on in separate corporations by two or more family members.[11] A consideration must be the extreme difficulty family members have in defining a fair division of properties. A revenue ruling which, unfortunately, would involve voluminous detail and substantial legal and accounting fees is always advised.

2. *Mortgage in Excess of Basis*

It is not unusual in the farm community to find situations where liabilities exceed the original cost basis. If the farmer were to sell property to his children, he would be immediately taxed on the excess of the liabilities over his basis.[12] A transfer by gift to the children or to a corporation would have similar results.[13] None of the traditional planning methods solve the problem.

One alternative is to retain the property until death. The estate then receives a stepped-up basis[14] and, assuming the property is appraised at more than the mortgage, the problem fades away. However, no estate planning takes place and the taxpayer has the unfortunate circumstance of either paying substantial income tax

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ordinary income to the shareholders upon liquidation of the corporation.

In the liquidation of farm and ranch corporations, this may mean that inventories of grain or cattle (not breeding cattle) could be included in defining earnings and profits under section 312(b) at their fair market value. *See* Rev. Rul. 79-149, 1979-1 C.B. 132.

Similar treatment would be given to growing crops.

I.R.C. § 311(c) taxes the distributing corporation where assets are distributed with liabilities exceeding the adjusted cost basis. I.R.C. § 312(c) adds such amount to earnings and profits increasing the ordinary income that would be taxed to the shareholder in a section 333 liquidation.

I.R.C. §§ 1245, 1250, 1251, and 1252 must be reviewed for recapture potential. Any recapture that occurs under these sections will likely be taxed both at the corporate level and shareholder level in a section 333 liquidation.

11. I.R.C. § 355(b)(1).

12. Donor has income to the extent the assumed liability exceeds the cost basis. Estate of Levine v. Commissioner, 526 F.2d 717 (2d Cir. 1980); Johnson v. Commissioner, 59 T.C. 791 (1973), *aff'd* 495 F.2d 1079 (6th Cir. 1974).

Mortgage in excess of basis is treated as paid in the year of sale. Treas. Reg. 1.453-4(c) (1958).

13. I.R.C. § 357(c).

14. I.R.C. § 1014(a).

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on lifetime transfers or having the entire property subjected to death taxes.

A distinction between the transfer of property to a corporation subject to liabilities in excess of basis, and the transfer of the same property to a partnership, is that the entire excess is immediately reportable by the corporation for income tax purposes. In a transfer to a partnership the excess is reportable as gain only to the extent that other partners assume a share of the liabilities.[15]

Assume that a husband and wife form a partnership and transfer to the partnership property with a mortgage in excess of basis. They receive partnership interests in the same ratio as ownership prior to the formation of the partnership. There is no gain taxable to the husband and wife upon the transfer. Now, assume that the husband and wife as parents give a five percent interest in the partnership to their son. Section 752 treats the parents as though they had withdrawn cash equal to five percent of the mortgage in excess of basis (taxable gain), and treats the son as though he had made a cash contribution to the partnership in that amount. Thus, the partnership gives the family in this situation the opportunity of estate planning without income tax on the entire amount of mortgage in excess of basis.

3. *Inflexibility*

What is conceived to be proper planning today is not always right for tomorrow. Once property is transferred to a corporation, the flexibility of shifting it in a different direction is virtually eliminated. How many times, for example, has a family transferred property to a corporation with the long-range objective of passing the family business on to two sons or to a son and a daughter whose husband is one of the primary working members? It is naive to believe that all of these types of situations will last for any substantial length of time.

III. Installment Sale

Most farmers who choose not to transfer their property to a corporation or partnership have strong feelings about retaining control of their business assets until retirement. This prevents the transfer of small acreages. Thus, the transfer of the entire business to the children normally would not occur until the parents have reached retirement age.

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15. I.R.C. § 752. *See* W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, 15-36 (1977).

Published by The Scholarly Forum @ Montana Law, 1981

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A. *Value Freeze—Reduced Estate Tax*

The installment sale has the benefit of freezing the value of the parents' estate for death tax purposes and of giving the buyer a stepped-up basis in the assets purchased. In addition, parents may use the payments for living expenses resulting in a substantially reduced value reportable in their estates. If the interest rate charged on the contract is less than the usual interest rate at the time of the parents' deaths, an additional discount is available for reporting the contract balance in the parents' estates.

B. *Obligor Relieved of Contract Balance*

Parents may devise the unpaid balance of an installment contract to a purchasing child. The old conflict between sections 1014 and 691[16] was resolved by the Installment Sales Revision Act of 1980. This act specifically provides that the bequest of an obligation to the original obligor is treated as a taxable disposition of an installment obligation.[17] This treatment is probably sufficient reason not to use the installment method.

C. *Other Factors*

Other factors also make the installment method unpopular. With the elimination of carryover basis other planning methods are available to eliminate the capital gain triggered by the mere signing of the contract.[18] For example, if taxable gain were $1,000,000, someone will be taxed at some point, on that gain. If partnership units or corporate shares were utilized, however, and if those partnership units or corporate shares were taxed in the parents' estates, those units or shares would receive a stepped-up basis and, thus, could be sold at the death tax values without any gain whatsoever.[19]

Other negative factors to consider are that (1) special use values under section 2032A are not available;[20] (2) a recently proposed regulation would increase the minimum interest that must be charged from six percent to nine percent to avoid imputed interest rates;[21] and, (3) elimination of the opportunity to make an election

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16. M. FERGUSON, J. FREELAND & R. STEVENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES, 295 (1970).
17. I.R.C. § 453B.
18. *See* I.R.C. § 691.
19. I.R.C. § 1014.
20. I.R.C. § 2032A is only applicable to property interests owned at the time of death.
21. *See* I.R.C. § 483 dealing with interest.

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under sections 6166 or 6166A to defer payment of death taxes attributable to interests owned in closely held business entities.[22]

IV. Private Annuities

The private annuity is a planning tool frequently discussed but seldom used. The principal reasons are (1) that the transferor relinquishes control over the property and may not retain a mortgage or other security interest; (2) uncertainty as to how many payments will be made; and, (3) that the obligor will be denied an interest deduction.[23]

The latter factor, particularly when land is involved, virtually eliminates the private annuity from consideration. Because inability to deduct interest increases the before-tax cost dramatically,[24] some other planning tool should be used.

V. Use of Partnership Entities

Business and estate planning in the typical Montana law practice normally involves use of the corporate entity. Some common problems experienced in using corporations are (1) distribution of property by a corporation is a taxable event; (2) dividend income from a corporation is taxed twice; (3) it is difficult for parents to sell part of their shares to the corporation and retain part because the entire sale proceeds might be taxed as a dividend.

As a result, in most instances, farm land property should be transferred to a corporation only when it is encumbered with a substantial amount of debt. Even this may not be justified if the parents have no current income tax problems or if the planning goal is to divide the farm property in-kind among their children. If none of the traditional planning tools fit the bill, is there a practical alternative? In most instances, use of either a general or limited partnership will accomplish amazing results. For example, if the

22. The 65% threshold of I.R.C. § 6166A or the 50% threshold of I.R.C. § 6166 would be difficult to meet.

23. *See generally* [1980] B. Ellis, *Private Annuities*, 195-2d Tax Mngm't.

24. The annual payment to amortize $1,000,000 over 30 years would be $72,650. Total interest would amount to $1,179,500. The following shows the *before-tax* income necessary to retire the debt assuming the taxpayer has a marginal rate of 50%:

Before-Tax Income Necessary	With Interest Deductible	With Interest Not Deductible
To retire principal	$2,000,000	$2,000,000
To pay interest	1,179,500	2,359,000
Total	$3,179,500	$4,359,000

family lives on the business premises, an attempt to take advantage of deducting living expenses under section 119 should be made. In that instance, both a partnership and a corporation can provide the optimum income tax benefits to accomplish planning goals.

A. *Retained Life Estate*

When structuring any business entity, caution must be exercised to reduce the possibility of having the entire value of the entity taxed in the original owner's estate. Section 2036, dealing with transfers involving retained life estates, would include the value of transfers where the decedent had retained income[25] from or control over[26] the transferred property. This section will only be applicable in cases of extreme abuse.[27] Application of section 2036 can be almost entirely avoided by (1) having the children contribute their own property, or (2) making a sale to the children of the business interest involved at fair market value.[28] If the particular entity has frozen and nonfrozen interests, the younger generation should receive the nonfrozen interests in exchange for their capital contribution or as the subject matter of a sale by the parents. The ratio between frozen and nonfrozen interest is a matter of personal judgment, but probably should not be greater than twenty frozen to one nonfrozen.

Notwithstanding the so-called anti-*Byrum* amendments to section 2036(b) in 1976 and 1978, the use of voting and nonvoting stock should not cause a gift of the nonvoting stock to be taxed in the donor's estate. There is a distinction between a vote retained by the transferor *on the asset transferred,* and the transfer of assets that by law and contract (articles of incorporation, by-laws,

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25. I.R.C. § 2036(a).

26. I.R.C. § 2036(b).

27. In a 1970 technical advice memorandum, the entire partnership interest was taxable to the donor under I.R.C. § 2036, on the basis that the donor had retained the entire income from the partnership for her life. The donor transferred the partnership interests based upon requests from heirs to protect their situation under husband's will; income payments to donor were essentially equivalent to the entire income earned; donor dominated the business activity. Ltr. Rul. 7824005.

In another fact situation, decedent created a corporation in 1973 and transferred 440 acres of farmland in exchange for stock. He subsequently sold a portion of the stock to his children and gifted the rest. Decedent continued to treat the farmland as his own—he lived there, paid no rent, pastured his cattle and stored his equipment there. The corporation was virtually inactive. The I.R.S. concluded that the portion of the land attributable to the gifts was includable under I.R.C. § 2036 because he had retained possession, enjoyment and a right to income from the property. Ltr. Rul. 7837003.

28. I.R.C. § 2036 does not apply where there has been a "bona fide sale for an adequate and full consideration in money or money's worth."

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and stock certificates) have no right to vote.[29] The rationale of *Byrum v. United States*[30] and the applicability of substantive partnership law should prevent most multi-class partnership and corporate interests from being taxed under section 2036(b).[31]

B. *Structuring a Partnership*

Once a partnership is determined to be the right entity, the decision of whether to use a general or limited partnership must be made. General partnerships are much more susceptible to voluntary or involuntary dissolution, and all partners have a say in management. Most parents, if still active in the business, express the desire to retain control and limit the possibility of dissolution. Limited partnerships, therefore, are used more frequently. Maturity of the children and the degree of interfamily trust have a large bearing on this issue.

C. *General Partners*

Many potential problems pertaining to retained life estates under section 2036 can be overcome by having one or more of the children assist in managing the business. In a general partnership, the children should be allowed equal authority in business dealings. The same is true in a limited partnership for those children acting as general partners. It is probably unwise to have someone act as a general partner who is not actively engaged in the business. A nonactive general partner may become very uncomfortable with the potential legal liability of that status.

D. *Montana Partnership Law*[32]

Conducting a business as a partnership rather than a corporation places a substantially greater risk of liability on the parties. This risk can be diminished with adequate insurance coverage. Since personal guarantees generally are required of at least the principal owners of a business, borrowing by a partnership or a corporation presents the same amount of risk.[33]

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29. Section 702(1) of the Revenue Act of 1978, amending I.R.C. § 2036(b).

30. 408 U.S. 125 (1972).

31. *See* Abbin, *The Partnership Capital Freeze—An Alternative to Corporate Recapitalization,* 13TH ANN. INST. ON EST. PLAN., U. MIAMI L. CENTER, ch. 18, ¶ 1806.2 (P. Heckerling, 1979) [hereinafter cited as Abbin].

32. Montana has adopted the U.P.A. and U.L.P.A. *See* MONTANA CODE ANNOTATED [hereinafter cited as MCA] §§ 35-10-101 through -615, 35-12-101 through -403 (1979).

33. In making a loan to a closely held corporation, Montana banks generally ask for the personal guarantees of principal shareholders.

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A partnership is more susceptible to dissolution than is a corporation. Dissolution may be caused by a variety of voluntary or involuntary acts of partners,[34] or under certain circumstances, by decree of court upon application by or for a partner.[35] A limited partner has the same rights as a general partner to seek dissolution by decree of court.[36] The right to cause the partnership to be dissolved by a decree of court is an area that must be carefully evaluated when deciding on the type of entity. One approach may be to have the partnership agreement provide that the partners have reviewed the rights, duties, and privileges afforded them under Montana law and agree that they will not exercise such privileges to terminate the partnership. Because MCA § 28-2-708 (1979) may make any limitation on access to the courts void, it is advisable that a partnership agreement have a severability clause. Whether the statute applies to a partnership is not certain. However, one must be aware of the potential of such a restraint.

One of the grounds for partnership dissolution by court decree is when further business of a partnership may be carried on only at a loss.[37] Many farms, however, routinely operate at a loss. At the same time, inflation in land values enables the farmer to borrow sufficient funds to continue the business. It is submitted that the courts should compare any inflation of land values with the negative cash flow to determine whether the partnership, in fact, had been operating at a loss.

In the absence of an agreement to the contrary, limited partners are not entitled to receive property on dissolution, but are merely entitled to receive cash.[38] The partners can, by agreement, amend the partnership agreement to allow distribution of other forms of property to a limited partner in exchange for partnership interest.[39]

E. *Property Suitable for Transfer to Partnerships*

1. *Land*

Land values have had a more predictable rate of growth than many other investments. This predictability makes farm property an excellent choice for developing an estate plan that would cap the growth of parents' estates. The partnership, general or limited,

34. MCA § 35-10-603 (1979).
35. MCA § 35-10-604 (1979).
36. MCA § 35-10-307 (1979).
37. MCA § 35-10-604(e) (1979).
38. MCA § 35-12-314(3) (1979).
39. *Id.*

is an ideal entity for holding land without adverse tax results due to the ease of transfer, and the fact that an individual's income is taxed only once.

The type of business arrangements to be used is more limited when land is transferred to a corporation. Even though the Subchapter S election allows corporate earnings to be taxed at the individual rates,[40] there are many limitations on qualifying for Subchapter S treatment.[41] One of the chief limitations is that "passive income" may not exceed 20 percent of the corporation's gross receipts.[42] Rent received for leasing farm land may therefore disqualify the Subchapter S election. Further, a corporation with more than one class of stock, may not make a Subchapter S election.[43] This latter restriction makes a Subchapter S unattractive because it eliminates the opportunity to use voting and nonvoting or preferred stock to cap the parents' estates.

The transfer of land to a corporation may, over time, confront the corporation with questions of improperly accumulated surplus,[44] or with the personal holding company tax.[45] These questions are never raised in the partnership setting.

2. *Livestock*

Ranchers systematically cull older breeding stock. Gain on the sale of breeding stock held for more than 24 months is reportable as capital gain.[46] Corporate taxation of this gain can vary dramatically from gain taxed to an individual.

A Subchapter C corporation does not receive a capital gain deduction,[47] but arrives at its taxable income by adding capital gain to its other income. The only tax relief available is the 28 percent maximum rate on capital gain.[48] An individual, however, receives a 60 percent capital gain deduction, thus, only 40 percent of the gain is added to other income to calculate tax liability. In most instances the individual tax will be less than corporate tax unless the individual is in the 70 percent bracket.

Where capital gain occurs with some frequency, as in ranch operations, a Subchapter S election is sometimes considered. Capi-

40. I.R.C. § 1373.
41. I.R.C. § 1371.
42. I.R.C. § 1372(5).
43. I.R.C. § 1371(4).
44. I.R.C. § 531.
45. I.R.C. § 541.
46. I.R.C. § 1231(b)(3).
47. I.R.C. § 1202(a).
48. I.R.C. § 1201(a)(2).

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tal gain retains its character when reported by the shareholders.[49] Subchapter S corporate debt, however, cannot be liquidated at the lower corporate tax rates. Where it is advisable to use a Subchapter C corporation to liquidate debt at lower tax rates, livestock should either be privately owned, or transferred to a partnership where capital gain retains its character when reported by the individual partners.[50]

3. *Growing crops*

Where the same taxpayer controls two or more business entities, the IRS may allocate income and deductions between entities to clearly reflect the income and to prevent evasion of taxes.[51] For transfers of land with growing crops, it is necessary to consider whether there will be a distortion of income at the individual level. In *Rooney v. United States*,[52] the transfer by a cash basis taxpayer of property with growing crops resulted in disallowance of farming expenses because the transfer distorted personal income.

If land with growing crops is transferred to a corporation, a Subchapter S election, with a fiscal year ending prior to December 31, should be considered for the first year of operation. Expenses disallowed to an individual will then become a deduction to the corporation. The Subchapter S election allows the expenses to flow through to the individual, resulting in an offset to recapture.

The transfer of growing crops to a partnership might present a similar problem. In nearly all instances, the partnership's fiscal year must end no later than December 31. Therefore, in spite of recapture, the partnership deduction in the same tax year would flow through to the individual. Note, however, that if there is recapture and substantial gifts are made, there could be a shift in tax consequences between taxpayers.

4. *Oil and Gas Properties*

At first blush, one might think that the partnership is an ideal entity to own minerals. Oil and gas income would be taxed only once. The parents could proceed with their estate plan, perhaps by freezing the value of such property in their estate, or by making gifts of partnership interests. The transfer of proven oil and gas property will result, however, in the loss of the percentage deple-

49. I.R.C. § 1375(a).
50. I.R.C. § 702(b).
51. I.R.C. § 482.
52. 305 F.2d 681 (9th Cir. 1962).

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tion.[53] Minerals should be transferred only after careful review of their production status.

F. *Cost Basis Information*

Prior to the transfer of property to any entity, detailed information should be obtained regarding the transferor's remaining cost basis. This information, when compared with the transferor's liabilities, may dictate the type of entity that should be used. If the liabilities exceed the transferor's adjusted basis, the transfer of such property to a corporation will cause the excess to be immediately taxed as gain to the transferor.[54] If the property were transferred to a partnership, however, any potential gain would be taxed only to the extent that the transferor was relieved of such liabilities, i.e., the percentage interest of the partnership received by some other party.[55]

G. *Investment Credit Recapture Problems*

Property on which investment credit has been taken should not be transferred to an entity until the potential of investment credit recapture has been thoroughly reviewed. Recapture on such a transfer can be avoided if (1) the property is retained as section 38 property in the same trade or business;[56] (2) the transferor retains a substantial interest in the trade or business;[57] (3) substantially all of the assets necessary to operate the trade or business are transferred;[58] and, (4) the basis of the section 38 property is determined in whole or in part by reference to the basis of the transferor.

If less than the entire business is transferred, the section 38 property should be retained until the necessary lapse of time cures the problem. The original owner can enter into a variety of contractual arrangements for the use of the property without suffering recapture. The original owner can be in the custom farming business, lease the equipment, or rent the equipment. After the new entity is created, new equipment should be purchased by the new

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53. I.R.C. § 613(a) and (b).
54. I.R.C. § 357(c).
55. I.R.C. § 752.
56. I.R.C. § 47(b).
57. *Id.*; Treas. Reg. § 1.47-3(f)(2) (1967).
58. Rev. Rul. 76-514, 1972-6 C.B. 11. Substantially all means *all*. *But see* Ramm v. Commissioner, 72 T.C. 671 n.5 (1979) (questions validity of this requirement); Long v. United States, 79-2 U.S. Tax Cas. ¶ 9612 (W.D. Tenn. 1979) (holding this requirement invalid).

entity to avoid noncorporate lessor problems.[59] If livestock is not transferred to the new entity, the owner can continue a cattle operation by paying rent to the new entity for the use of the entity's land.

If less than the entire business is transferred to the same entity, some recapture problems cannot be avoided. The transfer of a portion of the land with improvements such as grain bins, corrals, fences and reservoirs, may result in recapture under the "substantially all" test referred to above.

H. *Qualification for Social Security Benefits*

A general partnership may not be the proper entity when parents near retirement age. Income from an active trade or business conducted by a general partnership must be reported as self-employment income by the partners.[60] This may disqualify a retired partner in a general partnership from drawing social security benefits.[61] Because of this result, a limited partnership may better suit the circumstances. Partnership income, taxable to a limited partner who performs no services, is not reportable as self-employment income.[62]

I. *Capital Freeze*

Farm lands and other real estate investments have inflated dramatically since World War II. To most business people and farmers, it appears likely that these properties will continue to increase in value. Farm property provides the ideal opportunity for structuring a partnership with frozen interests given to the parents and the regular interests given to the children. An interest is "frozen" by placing a fixed redemption value on that partnership interest. Commentators believe that the value so placed on those partnership interests will govern for gift and estate tax purposes.[63] The freezing of the parents' estates enables them to set up an annual gift program, and in most instances, to substantially reduce death taxes payable on their estates.

Consideration should be given to income preferences and pri-

59. I.R.C. § 46(e)(3). *See* [1977] J. Lyon, A. Schreiber & W. Donald, *Investment Credit—Qualification; Computation,* 191-4th TAX MNGM'T A-65.

60. I.R.C. § 1402(a).

61. Currently, the earnings limit for persons under 65 is $4,080 and for those over 65 it is $5,500.

62. I.R.C. § 1402(a)(12). *See* U.S. Department of Health, Education & Welfare, HEW Publication No. (SSA)77-1035R, Social Security Handbook, § 1102 (1978).

63. *See* Abbin, *supra* note 31, at ch. 18.

orities in order to assure parents of adequate income even though they no longer retain any inflatable interest. As added protection for the parents, the partnership agreement may provide parents with the right to force the partnership to purchase a small number of units each year in the event that the anticipated income levels are not met.

J. *Partnership Operation*

In most instances, it is advisable that the partnership carry on an active trade or business. To be considered active, the partnership is required to materially participate in the particular business. Material participation in farming requires risk of crop loss and risk of expenses.[64] The standard crop share farm lease will not constitute material participation.

Proper planning requires a review of funds available to pay death costs. Presently, if the taxable entity is properly structured and operated, appropriate elections can defer both state and federal death taxes up to 15 years.[65] Interest on the deferred taxes will amount to only four percent. Every effort should be made to advise the client of deferral benefits to see if planning goals can be met while maintaining eligibility for the elections on the death of one of the partners.

K. *Living Expenses*

For convenience, many farmers choose to live in small communities rather than in the country. Thus, in many instances, living expenses are not deductible even if a corporate entity is used.[66] In these instances, assuming there is no significant land debt, a partnership is more logical.

If a farmer is residing on a farm, every effort should be made to qualify for living expense deductions by the business entity and exclude those items from the individual's taxable income. A corporate entity may be the logical choice for at least a portion of property involved, with the balance of the property transferred to a partnership with more flexible business arrangements.

Only the Tax Court[67] and the Fifth Circuit Court of Appeals[68] have ruled that partners can be treated as employees for the pur-

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64. I.R.C. § 1402(a)(1).
65. I.R.C. § 6166.
66. I.R.C. § 119 (employee must live on the business premises).
67. Papineau v. Commissioner, 16 T.C. 130 (1951).
68. Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968).

poses of section 119. The Third,[69] Fourth,[70] Eighth[71] and Tenth[72] Circuits have ruled to the contrary. The Ninth Circuit has not yet ruled on this question.

L. *Tax Liability*

A partnership is not a tax paying entity.[73] All income, gains, loss or credit of the partnership are reported on the individual returns of the partners.[74]

M. *Taxable Years*

In computing the taxable income of a partner for a given year, the partner includes the gain, loss, deduction or credit of the partnership for any taxable year of the partnership ending with or within the taxable year of the partner.[75] The partnership, unless otherwise permitted, must adopt the same taxable year as that of the principal partners.[76] The secretary of the treasury will generally approve a request by a partnership to adopt a taxable year other than that of its principal partners, if there is not more than a three-month differential. Since most individual taxpayers report their income on a calendar year basis, most partnerships with approval could adopt a taxable year ending either September 30, October 31, or November 30.

The ability to use a taxable year other than that of the principal partners may allow deferral of income tax for a whole year. Different business operations have their own unique features. For example, ranchers normally do not sell their calves until late fall, just prior to cold weather and heavy snow. If the sale occurs after the close of the partnership taxable year, the income from the sale is not reportable by the partners until the following year.[77] The wheat farmer, who frequently defers the receipt of income from the sale of wheat to January, can receive cash for the sale of grain three months sooner by using a September 30 partnership taxable year end. This saves storage cost, inventory tax and bank charges,

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69. Commissioner v. Robinson, 273 F.2d 503 (3d Cir. 1959), *cert. denied*, 363 U.S. 810 (1960).
70. Commissioner v. Doak, 234 F.2d 704 (4th Cir. 1956).
71. Commissioner v. Moran, 236 F.2d 595 (8th Cir. 1956).
72. United States v. Briggs, 238 F.2d 53 (10th Cir. 1956).
73. I.R.C. § 701.
74. I.R.C. § 702.
75. I.R.C. § 706(a).
76. I.R.C. § 706(b). A principal partner is a partner having a 5% or more interest in the partnership. *See* Rev. Proc. 72-51, 1972-2 C.B. 832.
77. I.R.C. § 706(a).

and reduces the risk of insolvency of the elevator as well as deferring income reporting for another year.

N. *Optional Adjustment to Basis*

Farms and ranches normally have an inventory of raised products, e.g., crops or cattle. When a sole proprietor dies owning raised grain, for example, the estate's cost basis in that grain will be stepped-up to equal the fair market value of grain on the date of the decedent's death.[78] This is a very important financial consideration because those raised products can then be sold by the estate without incurring significant income tax liability.

A partnership may file an election, on the first return following the death of a partner, allowing adjustment of the deceased partner's basis.[79] Thus, the basis will be stepped-up to equal the amount reported for death tax purposes in the deceased partner's estate. While this optional adjustment to basis not only allows the tax-free sale of raised products, it also affords the estate an increase in basis of all underlying assets owned by the partnership. This increase may give the estate additional depreciation or a growing crop deduction, thus reducing the income normally taxable.

In somewhat the same context, a partnership is permitted a pro rata distribution of raised products without being required to report that income at the partnership level. This distribution allows the estate to receive its share of such items for the purpose of raising cash and allows the other partners to speculate with their shares.

Opportunities relating to a stepped-up basis on assets are not available to a corporation. Although corporate stock at death receives a stepped-up basis equal to the fair market value reported in the estate, there is no beneficial effect to the corporation itself in reduction of income tax on the sale of raised products. The corporation may not make pro rata distributions of raised products without triggering income treatment of the distribution. Therefore, the income tax impact is less severe upon the death of a partner than upon the death of a corporate shareholder.

VI. CONCLUSION

Choosing the proper entity to meet the goals of the client as well as to maximize tax benefits is not an exact science. Partner-

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78. I.R.C. § 1014.
79. I.R.C. § 754.

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ships and corporations each have their respective strengths and weaknesses. With the continuing rise in the cost of living most taxpayers must pay their living expenses with after-tax earnings. Farmers who reside on the farm and who are incorporated may deduct their living costs as business expense. This benefit is generally not available to partnerships. Land should be transferred to a corporation only as a last resort or where there are significant income tax advantages. General and limited partnerships provide estate planning opportunities that can be obtained by using one of these entities instead of a corporation.

Inflation has forced everybody to try to find ways to freeze the value of their estates. This can be accomplished with either a corporation or a partnership but partnerships seem to have fewer problems and pitfalls associated with their use.