

Innovative Business Arrangements

October 2003

Business Structure Options for New Generation Co-ops

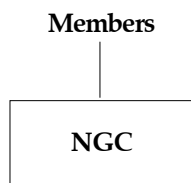
The purpose of this factsheet series is to help keep producers and processors informed about new ways of working together and the key issues and components of using alternative business structures.

The use of New Generation Co-ops ("NGC") in Canada could possibly be enhanced if combined with other traditional business structures such as a:

- Corporation
- Cooperative Partnership
- Cooperative Investment in Corporation
- Cooperative Limited Partnership
- Cooperative Joint Venture
- Cooperative Corporation

This factsheet outlines the pros and cons of each of these business structures as well as how they could be used in a New Generation Co-op arrangement.

Traditional Structure



Description

The traditional structure as defined in section 136 of the Income Tax Act, requires the cooperative to be incorporated under co-op legislation. 90% of the members must be individuals or partnerships/corporations who carry on farming businesses.

This structure may have limited use in a value added situation where significant capital is required for the purchase of hard assets.. The ability for non-farming investors to contribute capital for the purpose of purchasing hard assets is limited based on Income Tax Act restrictions.

This structure may only be applicable where producers have the capital to supply their own production facilities to the NCG. It would not be advisable however that the assets be transferred to or purchased by the NCG due to the inability to recover refundable dividend tax on hand (RDTOH) and pay capital dividends.

Advantages

- Flexibility on return of profit to members
- Patronage payments can be deducted before the NGC pays tax
- Individual investors are not liable for cooperative debt unless a personal guarantee is signed
- Small business deduction and manufacturing and processing deduction are available

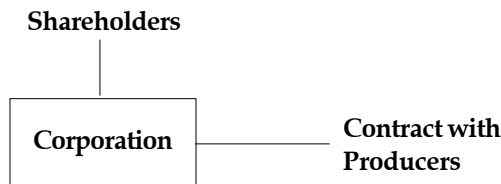
- The co-op is considered a separate taxpayer
- Section 85(1) of the Income Tax Act can be used to transfer property to the NGC on a tax deferred basis

Disadvantages

- Resources for capital expansion are limited
- Assets are subject to creditors
- Resources to liquidate may not be available
- Capital gains exemption not available on investment
- Members are restricted (90% of members must be individuals or partnerships/corporations who carry on farming business)
- Ability for co-op shares to qualify for RRSP investment is restrictive
- Not considered a private corporation; therefore, does not have a capital dividend account (CDA) or refundable dividend tax on hand (RDTOH)
- Capital gains in the co-op would not be integrated and therefore subject to a high rate of tax

Corporation

Description



A corporation is described as a traditional corporate structure with private investors. In a value added processing situation, the corporation would be responsible for processing and contracts with producers to supply raw materials.

This structure is useful where a limited number of producers require capital from outside investors to finance the operation or purchase of capital assets. Capital is contributed to the corporation by the investors. The corporation will contract with the producer(s) to supply the product. This arrangement would be most effective if the contract were with a limited number of producers to reduce complexity.

This structure has been implemented in Saskatchewan (the Leroy Ag Co-operative) to allow community members

to invest through a corporation in a swine operation. The corporation was responsible for the finishing of the hogs. Producers were required to supply the hogs and the feed on a contract basis.

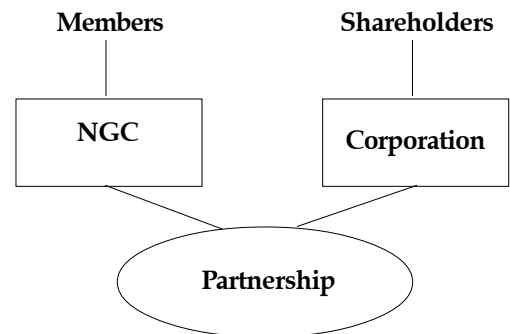
Advantages

- Investment is not restricted to producers therefore capital investment may be more readily available
- Limited liability for investors, subject to personal guarantees
- The corporation is considered a separate tax payer
- Small business deduction and manufacturing and processing deduction are available
- Section 85(1) of the Income Tax Act can be used to transfer property to the corporation on a tax deferred basis
- Corporation would accumulate RDTOH and CDA balances providing it is a Canadian controlled private corporation (CCPC)
- Shares of the corporation could qualify for the capital gains exemption providing it maintained qualified small business corporation status

Disadvantages

- Profits cannot be flowed through to the producer unless they are investors as well
- Dividends paid to the investors are not deductible for tax
- Non-capital losses are trapped in the corporation

Cooperative Partnership



Description

In a cooperative partnership structure, the NGC forms a partnership with a corporation to produce the product. The NGC provides the raw materials and the investors

supply capital to purchase hard assets which remain in the corporation.

This structure could be used where various producers are required to supply a product but do not have the capital for the purchase of hard assets for processing or marketing the product. This structure may be used where the corporation is a new start up or is an existing production corporation.

The partnership may be appealing to the corporation rather than contracts with individual producers, as less time may have to be spent on negotiating individual contracts.

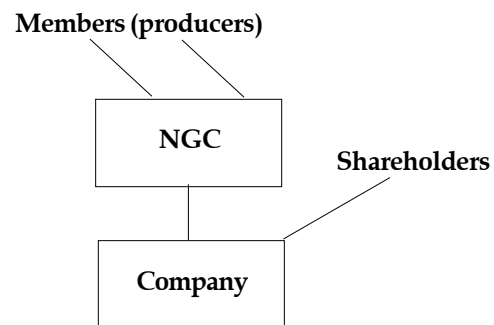
Advantages

- NGC can maintain status under Section 136 of the Income Tax Act
- Non-agricultural investors can contribute capital through the corporation
- Partnership agreement would allocate profits
- Investment in corporation is transferable (saleable)
- Section 85(1) of the Income Tax Act can be used to transfer property to the NGC on a tax deferred basis
- Corporation would accumulate refundable dividend tax on hand (RDTOH) and capital dividend account (CDA) balances providing it is a Canadian controlled private corporation (CCPC)
- Limited liability for investors, subject to personal guarantees
- Shares in company may qualify for capital gains exemption

Disadvantages

- Additional administrative costs related to operating the partnership
- Corporation and NGC would have to share the small business deduction limit
- Disposition of partnership interest by NGC would result in high rate tax with no refundable dividend tax on hand (RDTOH)
- NGC and corporation are joint and severally liable for actions of the partnership

Cooperative Investment in Corporation



Description

In this structure, the NGC holds shares in the corporation and enters into a contract to supply product. Non-agricultural investors contribute directly to the corporation in exchange for shares. The corporation holds hard assets and has active operations.

This structure would have very limited use due to the inability to flow capital dividends to the NGC or recover refundable dividend tax on hand (RDTOH).

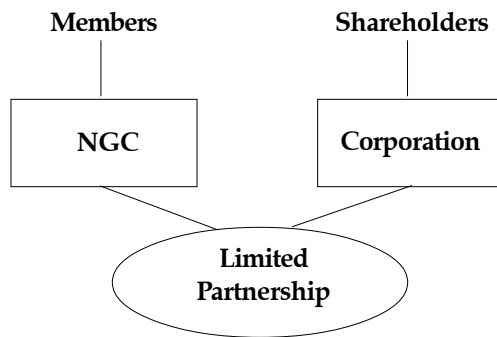
Advantages

- NGC can maintain status under Section 136 of the Income Tax Act
- The operating company deals with the management of the NGC rather than all of the producers
- Capital gains exemption may be available for the individual shareholders of the corporation
- Tax free dividends can be paid to NGC providing the corporations remain connected, however if a dividend refund results, the refundable dividend tax on hand (RDTOH) will be trapped in NGC

Disadvantages

- Refundable dividend tax on hand (RDTOH) and capital dividend account (CDA) balances cannot be flowed through to NGC. Two classes of common shares could be used to circumvent RDTOH and CDA problems.

Cooperative Limited Partnership



Description

In this arrangement, the limited partnership would be the operating entity. An NGC would act as the general partner and the capital company would retain limited partnership rights. The capital company would retain the hard assets.

This structure could be used where various producers are required to supply a product but do not have the capital for the purchase of hard assets for processing or marketing the product. This structure would be most applicable where the corporation is a new start up which is strictly structured to provide investment capital.

The limited partnership may be appealing to investors as any loss would be limited to their investment.

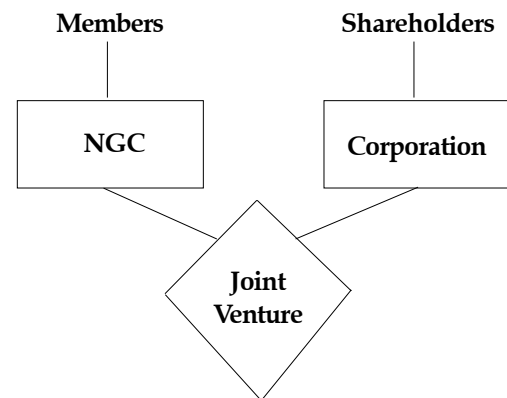
Advantages

- NGC can maintain status under Section 136 of the Income Tax Act
- Non-agricultural investors can contribute capital through the corporation
- NGC would retain control over operations of the limited partnership
- Investment in capital company is transferable (saleable)
- Corporation's liability risk would be limited to the amount invested

Disadvantages

- Additional administrative costs related to operating the partnership
- Disposition of partnership interest by NGC would result in high rate tax with no refundable dividend tax on hand (RDTOH)
- Shares in company may not qualify for capital gains exemption
- Flow through of losses would be restricted to the corporation

Cooperative Joint Venture



Description

In a cooperative joint venture, the NGC supplies product and the corporation supplies capital or hard assets. A joint venture has active operations. Shareholders provide capital to purchase hard assets.

This structure could be used where various producers are required to supply a product but do not have the capital for the purchase of hard assets for processing or marketing the product. This structure may be used where the corporation is a new start up or is an existing production corporation.

The joint venture would allow access to multiple small business deductions. This structure may be appealing to the corporation rather than contracts with individual producers, as less time may have to be spent on negotiating individual contracts. In addition, a joint venture would not have the same unlimited liability as a partner.

Advantages

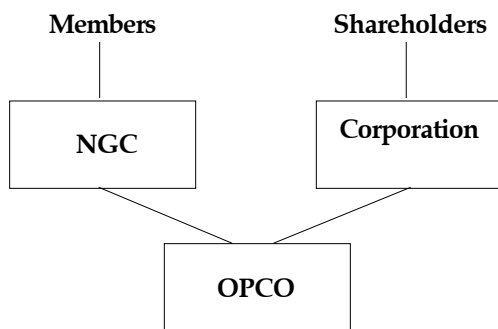
- NGC can maintain status under Section 136 of the Income Tax Act
- Non-agricultural investors can contribute capital through the corporation
- NGC and corporation would be eligible for small business deduction; however, the corporation would need more than five full time employees
- Not as difficult to discontinue a joint venture as a partnership
- Investment in corporation is transferable (saleable)
- Shares in company may qualify for capital gains exemption

- Corporation would be accumulate refundable dividend tax on hand (RDTOH) and capital dividend account (CDA) balances providing it is a Canadian controlled private corporation (CCPC)
- Limited liability for investors, subject to personal guarantees

Disadvantages

- Additional administrative costs related to operating the joint venture

Cooperative Corporation



Description

The operating company (OPCO) is responsible for processing and marketing. The NGC contracts with OPCO to supply product and the corporation contacts with OPCO to supply the hard assets for processing.

This structure could be used where various producers are required to supply a product but do not have the capital for the purchase of hard assets for processing or marketing the product. This structure may be used where the corporation is a new start up or is an existing production corporation.

The operating company would be a separate taxpayer; however, if multiple access to the small business deduction was considered, the taxable income of OPCO would be reduced to nil. The corporation provides flexibility in flowing profits to the shareholders as tax-free inter-corporate dividends could be used.

Advantages

- Dealing with one investor instead of many
- NGC and corporation may be eligible for separate small business deductions providing they disassociate with OPCO
- Tax free dividends can be paid to NGC providing the corporations remain connected, however if a dividend

refund results the RDTOH may be trapped in NGC

- NGC can maintain status under Section 136 of the Income Tax Act
- Investment in corporation is transferable (saleable)
- Shares in company may qualify for capital gains exemption
- Corporation would accumulate refundable dividend tax on hand (RDTOH) and capital dividend account (CDA) balances providing it is a Canadian controlled private corporation (CCPC). These could be flowed through to the investment corporation
- Limited liability for investors, subject to personal guarantees

Disadvantages

- CDA and RDTOH cannot be flowed through to NGC. Two classes of common shares could be used to circumvent RDTOH and CDA problems

Summary

The use of New Generation Co-ops (“NGC”) in Alberta as a business arrangement for producers and processors has potential to enhance the opportunities in the agriculture sector. By combining the NGC structure with other business arrangements, some management, legal and taxation issues might better be addressed.

There are pros and cons to all business structures, and managers should investigate the potential for their use with their business professionals.

Resources

This information comes from a technical paper researched and written by Dean Gallimore, C.A., Office Managing Partner, KPMG, Lethbridge, Alberta.

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