Joint Ventures in Agriculture

With land prices, input costs and machinery prices increasing, there are resulting pressures for farming operations to increase in scale to ensure they are obtaining sufficient margins to cover these costs. Joint ventures are becoming a more common business arrangement among farmers to assist in increasing their scale of operations. Similar to partnerships or corporations, a joint venture is a more flexible option for groups who want to work together without merging their entire operations.

What is a Joint Venture?

A joint venture business arrangement is similar to a partnership, however, joint ventures are not explicitly defined in the Income Tax Act ("the Act"). Therefore, defining joint venture characteristics for purposes of tax planning becomes difficult. There are some key differences between partnerships and joint ventures which assist with defining a joint venture. They are listed as follows:

	Joint Venture	**Partnership**
Term of existence	Has a specific term of existence. Either defined as a specific time period or when a specific outcome is accomplished	Has an undefined term
Profit allocation	Members share percentage of revenue and expenses based on their percentage of contribution	Partners share in net profits of the operation
Financing	Joint Venture is unable to borrow money. Must be borrowed by the individual members	Partnership's name can be used for financing
Ownership of assets	Members retain ownership of assets contributed to joint operations	Joint ownership of property
Registration for tax purposes	No formal registration required. Tax reporting is combined with members' regular reporting	Formal registration as a partnership with separate tax reporting
Contractual obligations	Members bind themselves into contractual obligations as opposed to all members of the joint venture	Each partner has ability to contractually bind the other partners through partnership contracts.

Why a Joint Venture

Unlike a partnership, a joint venture can allow individuals to combine resources but retain ownership to create larger operations. Essentially, it provides the opportunity to create a business structure that will combine all operations of each of the members and provide diversification, but allows each farmer to operate on their own land. The structure can prove to be tax efficient and reasonably simple to administer. In addition, a joint venture provides some stability to the members as a member has provided a commitment, creating an environment where each member is in it for the longer term.

Example – Mega Farm

Background

Let's assume a group of 3 incorporated farms want to work together for their mutual benefit. Some items they want to take advantage of include their respective strengths (and mitigate their individual weaknesses), to add to their diversification (both in terms of crops grown and land base) and to take advantage of larger purchasing power.

One of the considerations in implementing the structure is to ensure full access to the small business deduction for income tax purposes for each of the incorporated farms. The small business deduction allows corporate entities whose taxable capital base is below $15 million to take advantage of a lower income tax rate for taxable income below $500,000. In addition they want to ensure the structure can deal with assets that would be jointly owned (i.e. equipment) in as simple a manner as possible

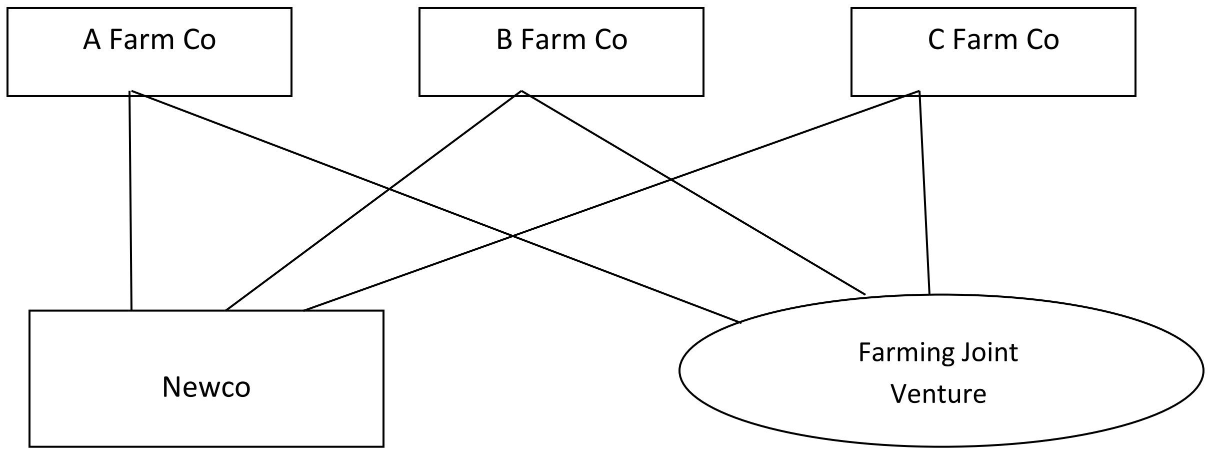
Structure

The farmers decide to use two entities, a joint venture to carry on the operations and a limited company to own equipment and do some of the contracting (for example employees or crop contracts).

The limited company is owned 33% by each of the farming corporation. Each farming operation moved all of its equipment from their existing corporations to the new limited company. For any inequalities between the farmers' asset contribution, differences will be made up with cash to ensure a 33% even contribution by each.

Ownership of the land remains with the individual farmers, and their portion of the joint venture profit is based on their land holdings and production opportunities.

Terms will be set to prevent any of the parties exiting the joint venture in the first 5 years, to ensure commitment and provide sufficient time for the operation to be successful. Subsequent to this period, a 2 year notice period will be required.



How it works

The existence of the limited company ("Newco") makes the structure easier from a practical point of view when trading equipment or negotiating contracts. While the intent is almost all income and expenses will go through the joint venture, when it comes time to purchase or lease equipment or to sign contracts, the limited company is a legal entity that can easily make these arrangements where a joint venture may have difficulty.

As the income will be generated in the joint venture through farming operations, this income is allocated to each of the 3 farm corporations. In tax legislation, income from a joint venture is treated differently than income from a partnership when it comes to the small business deduction and paying tax at the lower corporate rate.

If corporate entities are partners in a partnership, the income generated by the partnership must share the $500,000 small business deduction threshold. Therefore, if the partnership generated $700,000 of taxable farm income, $200,000 of that income would be taxed at a higher rate.

When the income is received by a corporate entity as a result of its involvement in a joint venture, the partnership rules do not apply, and each company would have access to the $500,000 small business deduction. Therefore, in our example, if the joint venture generates $1,500,000 of taxable farm income and assuming each corporate entity receives 33% (and that they had no other taxable income), all of the income would be taxed at the lower corporate rate.

Allocation of Joint Venture Income and Expenses

Using the example, the chart below is used to illustrate how the income and expense allocation among the individual farmers could be determined.

Details	A Farm Co.	B Farm Co.	C Farm Co.	Joint Venture
Fair Market Value of Assets Contributed to the Joint Venture				
Land	200,000	300,000	50,000	550,000
Buildings and Improvements	80,000	70,000	-	150,000
Machinery and Equipment	125,000	75,000	100,000	300,000
Other Assets	0	0	0	0
Total Investment	405,000	445,000	150,000	1,000,000
Percentage Investment (%)	40%	45%	15%	
Labour and Investment Calculations				
Salary for Labour and Management	20,000	15,000	25,000	60,000
Return Desired on Land — 4%	8,000	12,000	2,000	22,000
Return Desired on all other assets — 6%	12,300	8,700	6,000	27,000
Total Investment Allocated	**20,300**	**20,700**	**8,000**	**49,000**
Joint Venture Income and Expense Allocations				
Revenue from Joint Venture				560,000
Operating Expenses of Joint Venture				351,000
Net Income of Joint venture				209,000
Amount allocated as Salary	20,000	15,000	25,000	60,000
Balance after Salary allocations				149,000
Amount allocated as Interest on Investment	20,300	20,700	8,000	49,000
Balance after Interest allocations				100,000
Amount allocated Based on Percentage of Initial Investment	40,000	45,000	15,000	100,000
Balance after all allocations				0

Share of Joint Venture Income	80,300	80,700	48,000	209,000
Percentage Share	38%	39%	23%	
Allocation of Revenue	212,800	218,400	128,800	560,000
Allocation of Expenses	132,500	137,700	80,800	351,000
Allocation of Gross Profits	80,300	80,700	48,000	209,000

The Issues

Other industries use joint ventures as a critical part of the expansion of their investment opportunities and risk management. Producers in the agricultural industry are under increasing pressure to find these opportunities in a business that increasingly demands economies of scale, leveraging and diversification.

Critical to the effective development of a joint venture structure is the recognition by each potential participant that they are willing to work in an environment in which they may not be the boss.

There is a propensity to approach this structure from a "committee" point of view. A business structure with a boss or CEO role is absolutely necessary. The mindset of these structures is to utilize the committee approach but there also has to be someone in place to where the buck ultimately stops. If the participating farmers can get past this issue and support a formalized business structure then they have planted the seeds of a successful business organization.

Another critical component of a successful farming joint venture is the development of a financial model that projects to the farmer what his individual bottom line will be in this new structure. This model has to answer the questions of whether the farmer will be better off financially through their involvement in this process.

Exit Strategy

As mentioned earlier, it is strongly suggested that the joining group considers setting parameters around a minimum time period that each individual operation will be committed to the joint venture. This ensures a sufficient time investment to realize the full benefits of the union.

Taking our example, what happens if one of the individuals wants to exit from the joint venture? Looking strictly at the joint venture portion of the structure, when an individual operation decides to walk away, the process of "splitting" the business is straight forward. Land base was retained by the individual venturer, making it possible for an operator to remove their land from the mix and continue on their own.

There would be a brief period where "truing up" would have to occur with regards to inventory held by the joint venture and any inputs held for next season. However, there is no tax consequence as a result of ending a relationship with a joint venture. The same is not true if you are part of a partnership or corporate entity.

Looking to the example, one issue with the structure that could cause a tax consequence upon exit is the corporate entity used to hold the equipment. To pull out an individual's portion of the equipment assets could create tax issues for the individual. These tax considerations should be investigated at the initial set up of the structure to ensure each individual is aware of the potential exposure and what the potential costs may be.

For the remainder of the individuals involved, when one operation exits, they will want to revisit the joint venture agreement and ensure the union still makes sense for all involved. Consideration may be given to finding another operation to join or perhaps it may make sense to dissolve the union altogether. Either way, the joint venture allows for the flexibility to add and remove operators as decided among the group.

The joint venture structure deals with many connected issues such as compensation for land ownership and the continued relationship between each farm and its current landlords. Many of these relationships are very personal and it is difficult to have one policy for the joint venture that satisfies every personal relationship. However, joint ventures can be a great tool for developing a successful and sustainable business operation which has the potential for long-term existence. If implemented properly, advantages and opportunities from the structure can be realized almost immediately.

Developed by:

Colin Miller, CPA, CA KPMG LLP Lethbridge
Joel Bokenfohr, Alberta Agriculture and Forestry Rural Development