Selecting a Business Structure for Your Farm Business

According to Statistics Canada there has been a decrease in the number of farms operated across Canada over the past number of years. Typically, the main reason we see this decrease is because farms are growing. As equipment becomes larger and producers become more efficient they are able to cover more area in less time. With agricultural processes and technology continue to evolve to add additional efficiencies, we continue to see consolidation and adaptation in the Canadian agricultural sector. As income rises and business demands change it's important for producers to evaluate the appropriate business structure for operating their farm. The majority of farmers operate their businesses as a proprietorship. Other options include partnerships, corporations, joint ventures, and cooperatives. There are various reasons to utilize each structure but it's important to compare each and determine what works best for your farm. Supporting the existing one by claiming "this is the way dad did it" or "it works for now" is not a strong approach, and may be costing your farm in ways you've never thought about.

The purpose of this document is to compare the various impacts of running a farm as a proprietorship, partnership or as a corporation and the various advantages and disadvantages associated with them. Factors like start-up costs, regular filings as well as specific tax treatments will be considered. In addition, this paper will consider the special circumstances of a new generation cooperative, when it may become a viable option and how this unique structure differs from your standard corporation. An additional option to consider is a joint venture structure which is covered in detail in this document: Joint Ventures in Agriculture

To help make this easier, let's consider a farmer who owns and operates a farming business in Alberta with total net taxable earnings for the year of $300,000. This farmer is asking himself "do I have the right structure for my farm"? We will look at the impact a proprietorship, partnership and corporation would have on his business, and outline the various factors that need to be taken into consideration.

(Note: $300,000 was chosen to reach each tax bracket in the example, farm incomes differ significantly and average incomes should be taken from Statistics Canada.)

Statistics Canada: Census of Agriculture, Farms Classified by Operating Arrangements for Alberta

Operating arrangements	***2001***	***2006***	***2011***
Total number of farms	53,652	49,431	43,234
Sole Proprietorship	30,409	27,815	24,459
Partnership	16,147	13,920	10,947
Corporation	6,857	7,411	7,592
Other Operating Arrangements	239	285	236

Source: Statistics Canada. *Table004-0007 - Census of Agriculture, farms classified by operating arrangements, Canada and provinces, every 5 years (number),* CANSIM (database). (accessed: 2013-09-25)

Proprietorship

One of the most common forms of operating a farm is as a sole proprietorship. According to the 2011 Statistics Canada survey approximately 57% of farms in Alberta operate as a proprietorship. One of the main reasons for this is - simplicity. Under this structure, farmers report their annual farm income on their personal tax return. All income earned can be reported on a cash basis and because they qualify for the filing extension, they are not required to file their personal tax returns until June 15th (although tax is due April 30) which in many cases gives the farmer the necessary time to get their books prepared without incurring additional charges.

In addition, any losses incurred from their business operation are eligible to be applied against other sources of income (for example any type of off-farm income) and reduce personal taxes payable. In the start up phase this can be a huge benefit to help with cash flows. As the business grows and the farmer becomes more established they may hire a bookkeeper and keep separate bank accounts just for their farming activities. Since they are operating on a cash basis they can stabilize their income levels through inventory purchases and optional inventory adjustments.

So for example, let's assume a farmer operating a business as a proprietor in Alberta has net taxable earnings of $300,000. They would be taxed approximately $110,000 as shown below:

Taxable income	Tax rate**	Estimated Taxes	
$11,635 - 18,690	15%	$ 1,000	
$18,690 - 45,916	25%	$ 7,000	
$45,916 - 91,831	30.5%	$ 14,000	
$91,831 - 126,625	36%	$ 12,000	
$126,625 - 142,353	38%	$ 6,000	
$142,353 - 151,950	41%	$ 4,000	
$151,950 - 202,600	42%	$ 21,000	
$202,600 - 202,800	43%	$ 0	
$202,800 – 303,900	47%	$ 45,000	*(Max Income for example $300,000)
$300,000 +	48%	$ 0	
		$ 110,000	

** Tax rate based on combined 2017 Federal and Alberta personal income tax rates

In the example above all of the income earned from the business is reported on the farmer's tax return. If the farmer is married or has a common law partner, depending on what their partner does for a living they may not be utilizing all of their tax brackets which could result in the family as a whole paying more tax than if the income from the farm had been split in a manner that would utilize both partner's tax brackets up to the 48% rate.

Partnership

Another common method of carrying on business in the agricultural sector is by way of a partnership. According to the 2011 Statistics Canada survey approximately 25% of farms in Alberta operate as a partnership. What this means is that two individuals have come together, contributed assets (sometimes not equally) and work together for a common goal of profit. Typically any earnings derived from the partnership are then split between the members of the partnership usually based upon some pre-arranged partnership agreement. This agreement is usually based upon initial investment and contribution to the operation of the partnership.

Partnerships can be as simple as a husband and wife arrangement where they are both actively involved in the day to day operations of the family farm and split earnings based on their contributions or could be as complex as a group of farmers running a business within multiple business sectors with varying levels of compensation based on a factor of both initial investment as well as current investment of time and energy.

Regardless of the circumstances, a partnership can be a very useful structure. This can be shown best if we return to our example of the farmer who has net taxable earnings of $300,000. If the farmer instead had a 50/50 partnership with his wife, the after tax implications would be significant as shown below:

Taxable income	**Tax rate****		**Taxes**	
$11,635 - 18,690	15%	$	1,000	
$18,690 - 45,916	25%	$	7,000	
$45,916 - 91,831	30.5%	$	14,000	
$91,831 - 126,625	36%	$	12,000	
$126,625 - 142,353	38%	$	6,000	
$142,353 - 151,950	41%	$	4,000	
$151,950 - 202,600	42%	$	0	*(Partnership Income split)
$202,600 - 202,800	43%	$	0	
$202,800 - 303,900	47%	$	0	
$303,900 +	48%	$	0	*(Max Income for example $300,000)
		$	44,000	
	# of Partners		2	
		$	88,000	

** Tax rate based on combined 2017 Federal and Alberta personal income tax rates

Just by utilizing a partnership, the farmer is able to utilize his own and his wife's lower tax brackets resulting in a significant tax savings (in this example $22,000in savings). Thus savings could then be put back into the farming business or used to increase the quality of life for the farmer. This example assumes there is no other additional income. This example also ignores any impact of Canada Pension Plan on earnings.

It is important to note that a farmer operating as a sole proprietor cannot decide on a whim to start farming as a partnership without significant potential tax implications (for example possible disposition of assets at their fair market value). In order to mitigate any negative tax implications professional advice should be sought to ensure the appropriate tax filings are submitted to the Canada Revenue Agency.

Although the tax implications are advantageous, partnerships don't come without their added costs. Depending on how they are setup, partnerships will usually require a formal agreement, separate accounting records, bank statements and even management functions. This more often than not will create added costs and in some cases unwanted stress. As such a partnership may not be for everyone, but in the right circumstance can be a very useful structure.

Corporations

When considering whether or not to incorporate one must first consider the advantages and disadvantages to doing so. According to the 2011 Statistics Canada survey approximately 18% of farms in Alberta operate as a corporation. Like proprietorships and partnerships, farm corporations are also in a unique position as they too are able to use the cash method to report their income for tax purposes. Ultimately what this means is there is no difference between what the net earnings would be between a corporation, a proprietorship or a partnership.

When considering whether or not to incorporate, it should also be noted that any of the assets owned previously by the farmer via a proprietorship or partnership can be transferred into a corporation on a tax-deferred basis. What this means is regardless of your current structure, the option of incorporating is a viable option and should be considered in the correct circumstance.

The small business deduction is one of the major reasons a farmer would want to incorporate their business. This deduction is available to Canadian controlled private corporations (CCPCs) on their active business income up to a limit of $500,000. Any income earned up to the small business deduction limit in Alberta is taxed at a combined rate of 12.5% (federally and provincially). When compared to a proprietorship or partnership this rate is normally significantly lower which can free up more after-tax dollars to use in the business.

To help illustrate this, let's go back to our example and assume a corporation has $300,000 in net taxable earnings, is operating in Alberta and qualifies for the small business deduction:

Net Earnings	$300,000
Taxes payable **	($37,500)
Net Earnings After Tax	$262,500

** Combined 2017 Federal and Alberta Tax rate of 12.5% used

As illustrated above, by utilizing a corporation and its lower tax rates more money can be maintained within the company by deferring tax which frees up capital to be used in the growth of the company and to pay down any debt more quickly. If however, the farmer is drawing all of the earnings out of the company as they are made and is not keeping any of the earnings generated in the business, then there is little to no benefit from a tax perspective. As shown below, assuming the farmer pays remuneration through the company to themselves personally via dividends, the net tax impact to the farmer is similar to the same scenario had the farmer operated the business as a proprietorship:

Dividends Issued (from above)	$	262,500
Personal Tax paid**	$	73,000
Corp tax paid	$	37,500
Total taxes	$	110,500

** Tax rate based on combined 2017 Federal and Alberta personal income tax rates. Dividend assumed non-eligible dividend.

The real benefit to incorporating comes when money is left in the corporation. As shown above, the difference in tax when the small business deduction limit is utilized can be significant. The longer those funds remain in the company and are not pulled out for personal use, the more capital that is made available to the company to earn more income.

New Generation Cooperative

Consider a farmer who wants to help mitigate some of the risks in his industry and feels that the best way to do this would be to enter into business with some of his neighbors to help sell their commodities. The belief being that together, if they market and sell the commodities of the group as a whole, they will help create economies of scale and reduce some of the risks associated with factors like sale price and selling costs. An alternative available that could meet these needs would be to consider a new generation cooperative (NGC).

Similar to a traditional cooperative a NGC would have the following features:

- It is a separate legal entity from its members

- It would exist for the benefit of its members
- Each member has one vote regardless of their investment
- Services are typically provided for the benefit of its members
- Investors can be given voting rights and some control over activities of the NGC
- Distribution of excess earnings can be made to members through patronage returns

Unlike a typical cooperative a NGC also has the following qualities:

- NGC's may have closed membership as long as the restriction to membership does not violate human rights legislation, allowing NGC's to become very focused and not diluted with external votes that may impact the purpose of the NGC moving forward.
- NGC's will typically require a much larger initial investment to membership, restricting certain parties from becoming involved in the cooperative's activities.
- Delivery rights can be restricted to members only. As such, depending on the NGC's policies surrounding membership, the members of a NGC can experience exclusive advantages offered by the NGC not available to their competitors.

Under a new generation cooperative the farmers would experience a number of benefits over simply forming a partnership or a corporation. Unlike any of the other options, a NGC would allow the issuance of patronage dividends and the payment of such dividends in many different ways including cash, credit to a patronage account, and issuance of new shares or simply an offset to each member's liability account to the cooperative. Utilization of one form of payment over another could ultimately result in the cooperative being able to generate a large source of capital of which no corporate taxes would be paid. This in turn could be used to help facilitate some of the goals of the NGC mentioned above, giving the NGC and its members a competitive advantage over their non-member counterparts.

For example, similar to our examples above, let's consider a new generation co-op that has $300,000 in net taxable earnings, is a cooperative of Alberta and qualifies for the small business deduction.

Net Earnings	$300,000
Taxes payable**	($37,500)
Net Earnings After Tax	$262,500

** Combined 2017 Federal and Alberta Tax rate of 12.5% used

Similar to a corporation, net earnings would be taxed at the same tax rate as a corporation and the net earnings after tax would be $262,500. There would be no tax advantage to setting up a NGC over a corporation. Cash flows and capital within the company would be the same as a corporation, and the amount of cash resources available to the NGC to carry out its functions would have been the same as if the farm group had just setup a corporation with a similar purpose.
Now consider the same cooperative but this time the cooperative issues patronage dividends in the amount equal to net earnings:

Net Earnings	$300,000
Patronage dividends	($300,000)
Net Earnings After dividends	$0
Taxes payable	$0
Net Earnings After Tax	$0

In this case the NGC would not pay any tax (although the members would). This would result in an additional $37,500 being made available to the NGC to help facilitate the goals of the NGC, and defer tax on amounts that would otherwise have been owing.

There are some other items to consider. The setup, management and day to day organization of an NGC can usually be quite costly. As well, some members may not like the “one member one vote” policy regardless of how many shares or quantity of investments a member may have; members are limited to having the same amount of say in how the organization is run as the next member. Another factor is that in order to qualify as an NGC at least 90% of its members must carry on the business of farming. Lastly, NGC‘s do not qualify for certain tax treatments that regular corporations get (like refundable tax on hand or capital dividend account), so depending on specific situations there may be a disadvantage from a tax perspective to using a NGC versus a partnership or corporation.

All of these factors should be taken into consideration, however NGC’s under the right circumstances can be a very effective tool in helping to meet the needs of its members and should not be overlooked.

Other Considerations

There are a number of other items that need to be taken into consideration when comparing the differences between the various structures.

<u>Start-up costs</u>

The costs to starting a business are typically the same regardless of what structure the farmer uses. The amount, type or even cost of assets required will not change regardless of the structure. That being said, if a farmer decides to start an incorporated business or partnership there are typically additional costs associated with this. Such costs could include incorporation fees, legal fees to set up a partnership agreement or unanimous shareholders’ agreement and other added costs (like additional yearly tax filings for the corporation or partnership). Although minimal at times, these costs can accumulate and for some farmers may mitigate some of the advantages that they were hoping to obtain.

<u>Legal/ Accounting costs</u>

With respect to professional fees the cost to stay up to date with regular filings can vary. Such factors like quality of records, market place and even the parties being engaged can have an impact on the price for such fees. That being said, typically the fees to deal with corporate filings are higher than if the farmer was to run their business as a proprietor. As such, this needs to be considered when factoring in whether to incorporate or not as the added cost may offset the benefits to do so.

<u>Capital Gains Deduction</u>

The $1,000,000 capital gains deduction is available to every individual on the sale of qualified farm property. This deduction is a very effective and useful tax planning tool which allows an individual to not pay tax on $1,000,000 of qualifying capital gains once in their life time (ignoring any Alternative Minimum Tax that may apply). In the case of a farmer that has been operating a proprietorship or partnership, there is the opportunity to transfer the assets of their business into a partnership or corporation and at that time trigger a gain eligible for this deduction. This allows the farmer (and potentially their spouse) to utilize his capital gains deduction which will bump up the cost base of those assets transferred and reduce any gains if disposed of in the future. This strategy can become especially useful when considering succession planning, estate planning or even trying to deal with life circumstances that may arise.

If land is put into a corporate entity it can restrict or make it more difficult for the farmer to utilize the capital gains deduction on their land. There is not this same restriction on a farmer who owns land personally or in a partnership. That being said, there can be good reasons to put land in a corporation (for example pay down the debt on the land more quickly) but the farmer must consider the capital gains deduction implications when proceeding with this.

Rollovers

When one person or entity transfers farming assets to another related party, this is most commonly referred to as a rollover of the assets. With respect to farming operations in Canada there are specific tax rules available that allow farming businesses to perform tax free rollovers on qualifying farm property.

For example, consider a farmer who wanted to transfer some land that he owned to his child on a tax deferred basis. The ability for the transfer to occur would be directly impacted by the type of structure the business operated under. If the business was operating as a proprietorship the land would be owned directly by the farmer and there would be options available to roll the land over. However, if the land was owned through a corporation, the farmer would not own the land directly but instead they would own the shares of the corporation that owns the land. As such, different rules regarding the rollover would apply and the process of transferring just the land over would become significantly more complex. So when deciding which structure is best, one will want to consider both the current and future circumstances of the business to help ensure all available tools are being used to best situate the business moving forward.

AgriStability

With respect to the AgriStability program, there is very little difference between the reporting requirements between a proprietorship, partnership and a corporation. All three structures would report the same information and would have the same reporting deadlines. Generally costs to comply with this program would not be impacted and the overall benefit obtained being consistent regardless of which structure a farmer chooses to utilize.

Summary

As shown above there are a lot of factors that need to be taken into consideration when determining whether or not a farmer has the right structure for their business. As demonstrated by our example of the farmer with net taxable income of $300,000, the choice to use one structure over another can directly change how much tax is paid and how much tax is deferred as shown below:

	Estimated Tax paid**
Proprietorship	$ 110,000
Partnership (50/50)	$ 88,000
Corporation - no remuneration	$ 37,500
Corporation - full remuneration	$ 110,500

** Tax rate based on combined 2017 Federal and Alberta personal and corporate income tax rates

All things being considered, the amount of tax one pays should not be the only factor considered when making this decision. As discussed there are a number of variables that can come into play and each one can have a significant impact on the viability of the business moving forward. As such, if you are considering a change in the way your business is structured you will want to contact a professional to help ensure you are taking into consideration all of the variables that could impact this decision and help you make the best decision.

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