

BUSINESS STRUCTURE

Based on the preliminary discussions you had, and possible decisions that were made in the Ownership Options topic, it's now time to explore actual methods of transferring your ownership.

NOTE: Business structure can be a complicated issue to work through. Make sure you talk to your accountant and lawyer about your situation and about options you may have. The following document provides an overview of the topic. **It is not meant to replace advice from professionals.**

The method suitable for any particular family depends upon many factors. A few of these factors are:

- number of family members (active in the farm and non-active)
- financial health of current farm business
- financial health of the retiring generation (could include sources of wealth and income other than from the farm)
- ownership structure of the current farm business
- management ability of on-farm family members
- borrowing capacity of the farm and its on-farm family members
- personal and family goals and objectives
- immediate or gradual transfer of ownership

Methods of Transfer

The basic methods of transfer are:

- sale
- gift
- bequest

Each particular method carries different tax implications when transferring property to others. The most suitable method also depends on the form of the business arrangement that will eventually be used as the way to transfer farm assets.

Transfer by Sale

Most farms will be transferred at least in part by a sale from one generation to the next. A sale is a direct way of making the transfer. A sale to the children provides capital money for the parents and non-farming children. Some friction within the family may arise over purchase price and repayment terms if parents are financing the sale.

Transfer by Gift

Few people can afford to give the farm away. However, most transfers within the family usually include some amount of gifting. Specific assets will be gifted or the difference between the full fair market value and the actual transfer price of the asset will in fact be a gift. Gifting helps the children get over the hurdle of paying for assets that have inflated market values. It helps a child gain some beginning equity in the farm. With this equity, the child has borrowing power to raise additional capital for the farm operation.

Gifting sometimes does not provide much comfort or flexibility for the parents. It removes a source of income, takes away control and eliminates the parents' opportunity to change their minds later. **Once it's given away, it's gone.**

Transfer by Bequest

A bequest is a gift upon death directed by one's will. A will is used to distribute your estate to named beneficiaries after death. A will should not be the only transfer method. However, it is an essential tool if a parent should die before the transfer plan is complete or as a final step in a transfer plan. It can be used for such things as forgiving debts still owed by the younger generation or distributing an inheritance to non-farming family members.

Many farm transfers use a combination of bequest, gifts and sales to reach a successful farm transfer over a gradual period of time. The appropriate combination of methods depends upon your specific situation.

NOTE: This summary of the Methods of Transfer does not intend to replace the advice of trained professionals. Accountants and lawyers should be consulted as they can assist you in these decisions.

Structuring the Transfer

There are several structures that can be used to transfer ownership of the farming assets to your successors. There is **no one right way** to structure the transfer of the farming operations. The ownership structure that best fits your situation will be specifically designed to meet the needs of your individual family and business circumstances.

The best arrangement must consider:

- the needs of the parents
- the needs of the children
- the value of the farming operation
- potential financing arrangements
- debt servicing capacity of the farm

Parents' Needs

An important consideration when deciding upon the appropriate method for turning over the farm property to the children is how much money the parents will need for living expenses for the rest of their lives. Many farmers spend their farming lives building equity in the farm, with the result that they are often asset rich but cash poor. If the assets are turned over to the children for nothing or little consideration, unless the parents have some other source of income, they could have very little left to live on.

Life expectancies are increasing so it is important to plan for a long retirement. It is also important to factor in an allowance for inflation. A two per cent annual increase in inflation approximately equals 22 per cent in ten years. A four per cent annual increase approximately equals a 50 per cent increase.

Younger Generation's Needs

Since a farm transfer generally occurs at a time of life when the younger generation's living costs are increasing due to marriage and a growing family, they must not underestimate these costs. The younger generation will require that the farm business will cover operating expenses, income taxes, loan repayments and investment. It also needs to provide enough income for family living expenses — as they currently stand and as they increase.

There is a caution here. The retiring generation typically is living on the farm while the younger generation often lives in town. When determining living expense needs for the younger generation, costs that are sometimes not considered when living on the farm need to be included. These may be utilities, automobile expenses and mortgage payments.

Selling Price

The selling price is determined, for the most part, by the willingness and ability of the older generation to assist the younger generation financially. Cash flow and debt-servicing capacity of the ongoing business are factored into the decision. Some assets will be transferred at or near fair market value; others will be sold for much less or even given as gifts. The total sale price is often determined through consultation with an accountant and includes the retirement and estate objectives of the parents.

Borrowing Arrangements

How are the children going to finance the property? A farm transfer plan may involve a transfer of the business using commercial financing or financing provided by the parents.

Note: Careful consideration must be made to make sure that the farm is viable. If cash flow cannot handle debt payments, family members who are financing the transactions are often the last to receive payment. This can, in turn, jeopardize their retirement.

Further, if the parents are providing financing or deferring payment, they by association assume some of the risks in the business and are not completely free from the farm until the last financial commitment is met.

Debt Servicing Capacity

The debt-servicing capacity of a business is the amount of money (from all sources of income) left after paying all operating expenses (including an allowance for family living expenses and income taxes) — before loan payments are made. This amount, then, is available for loan (interest and principal) payments.

Business Structures

Sole Proprietor

A sole proprietorship occurs when the business and all its assets are personally owned by one person (the sole proprietor). Income produced by the business is taxed to the sole proprietor personally. A sole proprietorship is the business arrangement that is easiest to form and organize. It is much less expensive to set up than a partnership or corporation.

Within a sole proprietorship, the owner is:

- in absolute control over all management decisions
- taxed at the personal, marginal rate in effect at the time
- able to do anything an individual citizen can do
- personally liable for all debts of the business and personal assets may be seized to pay off the debts of the farm

A sole proprietorship ends upon the death of the owner. The property may be transferred to another person upon your death, but the person receiving the property becomes a new business entity.

Partnership

A partnership can be defined as the relationship that subsists between persons carrying on a business in common with a view of profit. This definition covers cases where two or more people have specifically agreed to become partners. It also applies to any arrangement where, when there is no written agreement, the conduct of the people would indicate that they are carrying on a business together.

Generally, deciding if a partnership exists can be determined by reviewing the arrangement for the presence, or absence, of the following:

- The individuals are carrying on a business in common. Joint tenancy, tenancy in common, joint property, common property or part ownership of something such as land does not necessarily create a partnership — even though profits from the land may be shared.
- The parties involved plan to make a profit from the venture.
- All parties are prepared to share any losses that the business might incur.
- All parties participate (not necessarily equally) in management.

Types of Partnerships

There are two types of partnerships; limited and general. In most farming situations, partnerships will be classified as general. In a general partnership, each of the partners is liable for any debts incurred in the name of the partnership. In the case of a limited partnership, limited partners are liable for the debts of the partnership only to the extent of their investment.

It is evident that the question of liability is one of the key points regarding the partnership form of business. In a general farm partnership, each partner **is liable jointly and severally** with the other partners for debts and obligations incurred by the farm while they are partners. If for some reason the liabilities of a partnership exceed its assets, a creditor or injured party may sue the partnership and each partner or an individual partner for the full satisfaction of a claim. This is an extremely important point to keep in mind when entering a partnership agreement or a business arrangement which could be declared a partnership by a court action.

In addition to the liability aspect, partnerships can be grouped according to how the assets are owned. The main differences are basically the degree of ownership of assets by the partnership versus the partners to the agreement.

The following breakdown describes the range of possibilities for a farm partnership:

- Full partnership
 - partnership owns all assets
 - individual partners have an interest in the partnership only
 - this form of partnership most clearly parallels the concept of an independent entity
- Modified partnership
 - some assets are owned by the partnership and some assets are owned by individual partners
 - individual partners therefore have ownership of certain assets as well as a partnership interest
- Operating partnership
 - individual partners retain title to all assets used by the partnership
 - this type of partnership simply shares labour, income and expenses
 - a partnership interest would only be created through retained earnings

Partnership Profits

For income tax purposes, a partnership must calculate its net income as if it were a separate entity. However, no income tax is levied on partnership income as the partnership itself is not required to file a tax return. Instead, the net income (or loss) is allocated to each partner according to the sharing agreement. Partners must then include their share of partnership income or loss in their own individual tax returns. In effect, while net income is determined at the partnership level it is taxed at the individual partner level. Capital cost allowance on partnership assets must be accounted for at the partnership level. Profits may be shared in any manner agreed upon by the partners. The profit sharing ratio need not be predetermined nor does it have to be consistent from year to year. Normally, the sharing ratio should be consistent with the amount of capital and labour contributed by each member. Farmers

should be aware that the Canada Revenue Agency (CRA) has the discretionary power to reallocate partnership profits.

Special income tax provisions permit a rollover (deferral of tax) on the transfer of property to a partnership. These rollover provisions apply to land, buildings, machinery, quota and inventory.

When dissolving a partnership, the general rule is that assets are deemed to be disposed of at fair market value when a partnership is dissolved. This may result in capital gain (loss). However, special rules exist to defer the tax on the dissolution of a partnership in certain situations. These include:

- transfer of partnership property to individual partners
- transfer of partnership property to a limited company
- transfer of property from one partnership to another
- partnership dissolved with one partner continuing as a sole proprietor

Corporation

The corporation or company is a separate legal entity that exists independent of the shareholders or members who compose it. As a legal entity, a company can do many of the things that a person can do. For example, it may purchase, hold and transfer property, obtain financing and enter into contracts in its own name.

Owners of a company are known as shareholders. Their financial interest in the company is represented by ownership of shares. Once a farmer transfers property to a company, the company takes title to such property. In turn, the farmer has title to the allotted shares, which are held as personal property. The farmer may continue to control the farming business carried on by the company by virtue of shares held in the company, but the company is the legal owner of the farm.

The share structure that a company adopts can be critical in terms of transition and estate planning and taxation. Several classes of shares can be created, each offering varying benefits to its holder. Such factors as voting privileges, realization of dividends and equity participation will distinguish one class of shares from another. A company's equity financing is accomplished through the issuance of shares and notes. A note may represent a loan by a shareholder to the company, thus the shareholder becomes a creditor of the company as well.

Tax Considerations

The corporation differs from both the sole proprietorship and the partnership in that it pays its own taxes on earned income, whereas in the other two forms of organization, income is taxed in the hands of the partner or proprietor. However, shareholders in a company also pay tax on any dividends or salary received from the company.

Salaries are a deductible expense to the corporation, thereby reducing its taxable income while dividends do not.

Advantages of a Corporation

Farm Business Continuity

A company has perpetual existence. Provided that managerial responsibilities are shared by two or more shareholders, many of the problems that develop upon the death of a sole proprietor are avoided.

Transferability of Ownership

The corporate form of organization converts ownership of specific assets into more readily transferable preferred or common shares, which represent the ownership of the business as a whole. For estate planning purposes, it is much easier to implement an orderly transfer of shares from principal shareholders to children during their lifetime and after their death.

Tax Savings

A Canadian-controlled private corporation is taxed at lower rate than the personal tax rate. Tax savings, which are really a tax deferral, are only possible if profits are reinvested in the corporation. The withdrawal of profit as dividends, salaries, interest, rent, etc., will largely eliminate the tax deferral.

Limited Liability

The liability of a shareholder is limited to the value of shares owned. Investments outside the company are not required to be used to settle company liabilities. This advantage is lost if lenders require personal guarantees.

Disadvantages of a Corporation

High cost of incorporation

There are significant start-up costs and annual operating costs related to incorporation. Opening and annual financial statements must be prepared, along with a more complex income tax return. The services of an accountant are normally required, which could result in a high annual cost.

High Cost of Dissolution

Because there is no rollover provision when transferring assets out of a corporation the tax costs may be very high if and when dissolution occurs.

Extra Administration

More administration of a corporate farm business is required and it involves more work with lawyers and accountants.

Characteristics of a farmer who incorporates:

- consistent, high level of farm income and net taxable income
- income left in the company as opposed to flowing through the company to the shareholders
- large untaxed inventories

- paying a spousal salary (over \$30,000 per year)
- some debt
- capital gains exemption available
- estate freeze required

Transfer Options by Structure

Sole Proprietor

1. outright sale with commercial mortgage
2. sale with mortgage back (parents hold the mortgage)
3. agreement for sale
4. promissory note
5. option to purchase

Note: The income tax and business considerations associated with these options are complex and should be discussed with your competent professional advisors.

Partnership

1. Admit farming children as partners of the existing partnership.
2. Transfer partnership to a corporation.
3. Sell or gift partnership interests to farming children.

The income tax and business considerations associated with these options are complex and should be discussed with your competent professional advisors.

Note: Transferring a partnership interest creates a one-time opportunity to make use of an additional capital gains exemption limit. If you are presently operating as a sole proprietor and are considering incorporation as a way to enable the transfer, it could be very beneficial to first form a partnership and then, after a required (CRA rules) period of time, proceed to incorporate. As stated previously, contact your accountant.

Corporation

1. Transfer existing shares of the corporation to your farming children.
2. Estate freeze and transfer of growth shares to farming children.

The income tax and business considerations associated with these options are complex and should be discussed with your professional advisers.

Why is this relevant?

It is important to understand the different options available to you for the ownership transfer of the farm. This way you can begin to formulate a preliminary plan that accomplishes your transition goals.

How will this help transition planning?

- Simply, you need to understand all the options that are available to you before you make final decisions about implementing your transition plan.

Instructions

1. Family members actively involved in the farm should complete the exercise.
2. Based on the preliminary decisions you made in the Ownership Options topic and the information included in the introduction to this section answer the following questions:
 - a. Does the farm currently have the correct structure to implement the preliminary decisions from the Ownership Options topic?
 - b. If no, what changes might be beneficial or necessary to implement our preliminary plan?
 - c. What questions do we have for our advisors (specifically accountant) regarding current and potential business structure changes?
3. If you are unsure about any of the different structures and how they might apply to your situation, talk to an accountant and lawyer.

How does this apply?

Business structure is one of the most important parts of the transition plan. You can use structures to effectively implement your plan and to avoid paying tax unnecessarily.

You may refer to this topic when completing the Financial Performance – Transition Scenarios topic on page 133 where you will test your preliminary decisions to see if they are financially viable.



PLANNING POINTERS:

- It is appropriate to get a second opinion. You do not have to change accountants or lawyers. Simply, arrange for a meeting with another advisor and see what he or she has to say. There will likely be a charge for this information but will be a small investment compared to the value of the assets being transferred.



WHAT TO WATCH FOR:

- Decisions around business structure and ownership options can involve great sums of money. They can be complex and include several different options. Make sure you have all the information you need to make the decisions.

**EXERCISE:**

- There is no formal exercise for this topic. You can record your notes and questions for professionals on a separate piece of paper.

Next steps

Congratulations on completing this topic. You are now a step closer to having a transition plan for your farm. Please proceed to the next topic area on your Transition Plan, but don't forget to add any assigned tasks that were generated by working through this topic.