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*Ontario - Agric.*

# **ORGANIZING YOUR ONTARIO FARM BUSINESS**

by Kenneth F. Harling  
Jack H. Clark

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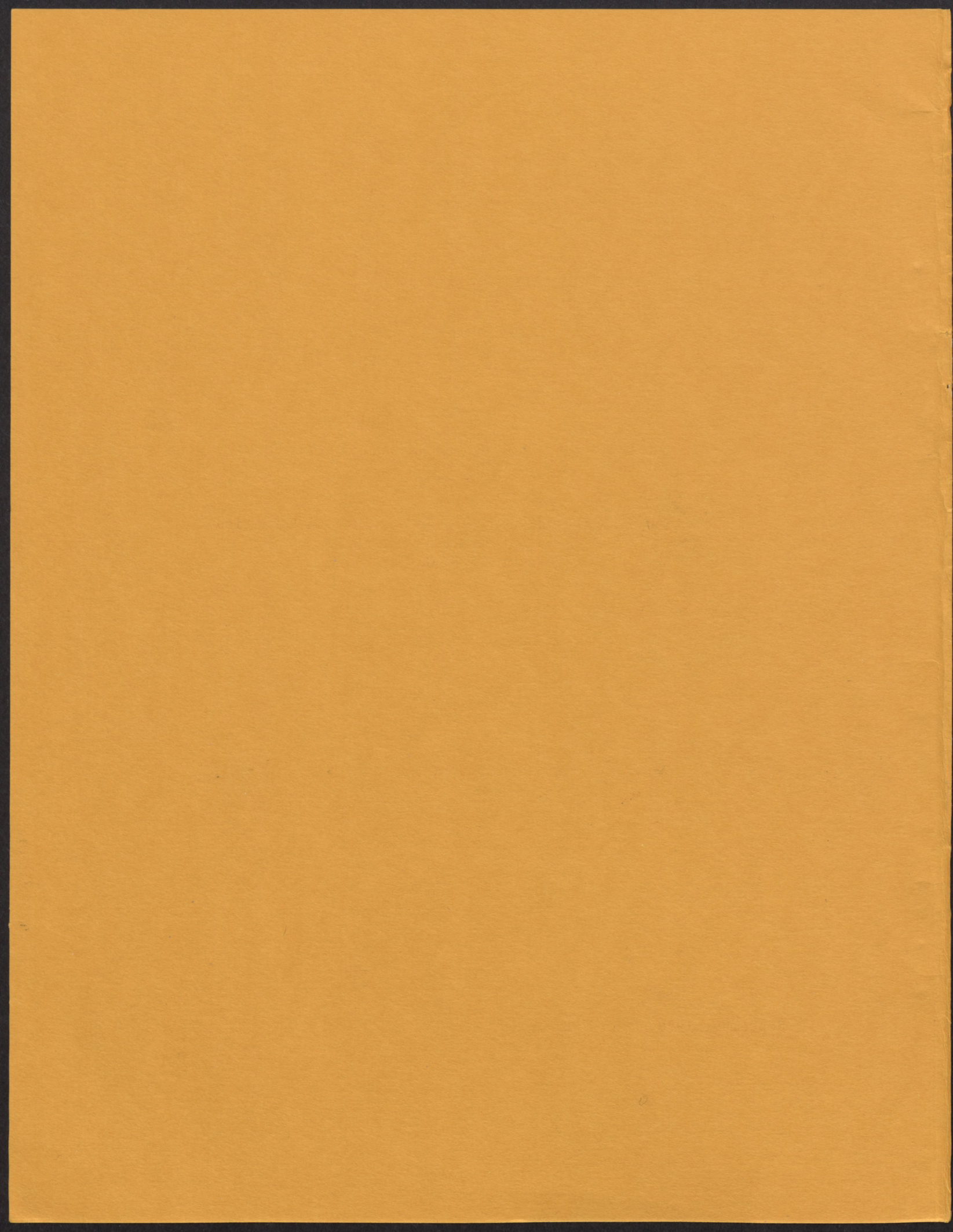
**School of Agricultural Economics and Extension Education  
Ontario Agricultural College  
University of Guelph**

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## PREFACE

An increasing number of young people are returning to the farm as farm opportunities and rural life appear increasingly attractive. Does a member of your family want to get involved in farming, particularly on the home farm? If so you will find this publication helpful. It describes the different ways in which family members can work together in a farm business.

This publication discusses the effect of different types of business organization on farm operation. Business organization also affects the details of farm transfers.

This publication is not a substitute for sound professional guidance and counsel. Familiarity with the material contained will save time and reduce the cost of help but it does not qualify the reader to deal with a very complex area. Professional help is well worth the money as it ensures that the business arrangement used will be legally binding and work as planned.

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### WHY BE CONCERNED ABOUT BUSINESS ORGANIZATION

High capital and managerial requirements of modern agriculture have resulted in increasingly complex and costly problems of entry and exit from farming. Older farmers seeking to retire find their life earnings tied to the farm plant. Their children find the capital investment too large in relation to their present resources.

Moreover, farming has been and usually still is a family affair. Many parents want the farm to stay in the family. Succession to the family farm seems a natural, logical objective for children interested in farming and having the same personal and business point of view as their parents.

The natural result is that a number of farms are being operated by two generations at the same time. This merging or "piggy-backing" of farm operations between generation alleviates many of the problems faced by father and son.<sup>1</sup> Father and son can build a larger and more efficient business by working together. Father can gradually retire as his son assumes an increasing role in the business. The son is assured of a future in the farm business, benefits from his father's experience and advice, and gradually builds up capital in the business. A suitable business organization is a way of getting this done.

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The words father and son, as used in this publication, may be interchanged with mother, daughter, son-in-law or daughter-in-law or any others who may be interested in working together in a farm business operation of a home farm.

### WHAT IS BUSINESS ORGANIZATION?

The business organization is the overall business structure that individuals can set up to operate a farm individually or jointly. The business arrangement is merely a set of decisions made by these individuals as to how the farm business will be owned and operated over time. Any arrangement must be based on one of the three basic forms of business organization or some combination of the three. The three are sole proprietorship, partnership and corporation. Each of these three are described in detail in a later section of this bulletin. The organizational form will set the legal and tax conditions which govern the operation of that part of the business. It is possible to set up a business arrangement which is a combination of more than one form of business organization. Two or more sole proprietorships may operate part of their business jointly through an income sharing agreement or a farm business agreement. The jointly operated part of the business may have some elements of a partnership but the essential business form may remain as two sole proprietorships. Alternatively a partnership or corporation may be set up to operate the major part of a business but many farm assets used may continue to be owned by individuals.

The business organization should be carefully planned to ensure that farm and family objectives are met during joint operation and later when it is transferred. Therefore, the complexity of any arrangement is highly dependent on the farm situation and the goals and objectives of the family. The arrangement must be tailor made for each farm. In certain cases relatively simple arrangements will suffice; in others more complex arrangements are needed.



The farm business arrangement often starts informally with a son taking on Junior Farmer or 4H projects. As he matures he can assume more active participation through a series of agreements. One of the first may be working for wages followed by enterprise or income sharing agreements. Eventually he may take over the entire business through a rental or purchase agreement or through a partnership or corporation when the father retires from active management.

#### ESSENTIALS FOR A SUCCESSFUL ARRANGEMENT BETWEEN INDIVIDUALS

The farmer contemplating setting up a business arrangement must realize that favorable conditions are essential for success. This is especially true of arrangements between parents and children. In such arrangements both personal relationships and business considerations are involved. The following is a partial list of factors necessary for a successful business arrangement.

#### ABILITY TO GET ALONG

Success or failure of a business arrangement depends heavily on the harmony existing between families. If they cannot get along before working together, they are not likely to get along after signing an agreement. Family unity, as well as the business, is at stake when there is discord between the two. Both should be able to get along well personally. They must have confidence in each other and respect the other's needs and desires. Goals and values of each must be compatible or compromised so that they have a common bond in making the business a success.

Not just father and son, but mother, brothers, sisters and the son's wife must be tolerant and understanding; overlooking each others faults. The wives are an especially important element in any arrangement. A wife, not quite happy with her situation, may complain about the long hours her husband works and/or his low level of earnings. This can create further friction by making her husband dissatisfied. Usually, if the wife has a voice in the business, understands its conditions, and is kept fully informed of business happenings, she is more likely to be satisfied.

#### HOUSING

Evidence indicates that separate housing should be available. A home for each family eliminates a possible source of friction. A good rule is that, "the farm should furnish separate and satisfactory housing either for both families or for neither one." If both families are provided with housing, it can be considered a business expense but furnishings and utilities should be private expenses. If neither is provided with housing, the parents' housing cost should be charged against their personal account.

There are a number of ways of acquiring additional housing if necessary:

- add another dwelling to the home farm; there should be a written agreement if one person is putting up his money for constructing or remodelling a home on land belonging to the other person.
- buy or rent a nearby farm unit with a suitable dwelling.
- rent a house in town.



- have the farm invest in a mobile home for one family.
- subdivide the farm house into 2 self-contained units: this is possible where the original dwelling is large and lends itself to such.

#### CAPACITY OF BUSINESS

A successful business arrangement between families requires that the business be able to generate enough income to maintain two families while compensating both families for use of their capital resources. There is no need to worry about division of income as long as there is only one operator on the farm. When there are two or more operators, it becomes important that they determine a suitable basis for sharing income.

Children can be disappointed with an arrangement if they are not earning enough or feel the division of income is unfair. They must remember that, while they may be contributing more labor, the parents are making a large contribution in management and capital investment. Parents must provide children with the opportunity to increase their equity and control in the business. The children's share of income should change as their contributions of labor, management and capital change.

No matter how income is divided, dissatisfaction is inevitable if total earnings are too low. The amount of income generated depends on the size and productivity of the farm. If a child returns to the farm, it may be necessary to reorganize and/or expand the business. The simplest ways are to improve farming practices and shift to enterprises requiring more labor.

Buying or renting land is one of the most popular ways of expanding operations. Modernizing, enlarging or adding buildings and improving

existing land are other ways which may be used to expand the farm business. Increasing the capital investment in the farm is not the only nor necessarily the best way to accommodate the son on the farm. The father may want to reduce his work load. This can make him reluctant to undertake heavy capital investment needed to expand the farm. Should this be the case, the son may take off-farm work part of the year or do custom work with farm machinery to augment income.

#### MANAGERIAL COMPETENCE

The ability to earn money is dependent on knowledge of good production practices, ability to make day to day decisions and wise use and investment of money. The successful farmer already has such abilities. A child starting farming often does not.

The son needs training and experience in management and production practices. He must be given responsibility in making decisions and transacting farm business from the start. He might make mistakes, but these can be kept to a minimum through discussions with the father. As the son develops ability and gains competence, he can be given an increasingly important role in management. The father should be creating opportunities for the son to take on further responsibility. At first these may include responsibility for certain enterprises or placing the son in charge during vacation time. Eventually the son should be able to assume responsibility for the whole farm. If he is not given sufficient responsibility, it can lead to friction and leave the son ill prepared to handle the business with the father's retirement or death.

Father and son should be able to work together and make decisions



jointly. The mutual understanding necessary for this depends upon the son's appreciation of the father's experience and mature judgement. He shouldn't be impatient with his father's conservatism in adopting "new-fangled" ideas. Change is rapid these days and fathers are often hesitant to risk an investment which has taken years to accumulate. On the other hand, sons may be venturesome having been exposed to new ideas away from the farm and having less to risk on their own.

Both father and son must use a little psychology to obtain willing and effective co-operation of the other. Joint decision making requires compromise -- give and take between the two parties. When there is honest disagreement, all aspects of the problem must be discussed fully. Information and advice should be sought from well-informed and disinterested outside parties (i.e., ag. rep., ag. college or progressive farmers) if there is widespread disagreement. Once the decision is made in light of the best information, it should be accepted, and acted upon.

#### A WRITTEN ARRANGEMENT

Some successful businesses have used verbal arrangements. However, verbal agreements tend to be vague, incomplete and lead to misunderstanding. Committing an arrangement to paper is strongly advised. It will not guarantee the success of the business but it will minimize some of the dangers of an informal arrangement.

A written arrangement has advantages for all parties:

- it is an aid in thinking through all terms of the plan in a definite manner.
- it forces both parties to give serious thought about the contribution and responsibilities of each.
- it gives formality and stability to the arrangement.

- it provides a blueprint for action, and
- it documents the intentions of the arrangement, allowing the results to be evaluated.

Well-written documentation also puts the business on a legal, contractual and business-like basis. The arrangement can constitute a legal contract between the individuals involved. Moreover, such an arrangement is presumably an arm's length transaction in which each party is fully informed and acting in their own best interest.

Revenue Canada is highly critical of informal arrangements because they look like nefarious schemes for "moving" income from a high to a low tax bracket and for transferring capital from one generation to the next circumventing taxes on capital gains of assets transferred. A contract, providing it is reasonable, establishes a basis for responding to Revenue Canada's questions regarding the sharing of profits and losses of the business. The written arrangement should also provide evidence of ownership as well as concessions and gifts that have been made. This protects the equity of either party in case of the other's death and is helpful in equitable treatment of the heirs when settling an estate.

#### FARM RECORDS

Joint business operations require business and production records for planning, budget, credit and tax purposes. Reasonably accurate records are also invaluable in the day to day management of the farm between operators.

The types of records that should be kept are:

- (i) Farm receipts and expenditures. These should be in sufficient detail to facilitate division of receipts and expenditures by category, at the end of the year. A joint bank account will help to maintain accuracy.
- (ii) A beginning and ending year inventory of farm property; as a minimum there should be a complete inventory of farm property showing the interest of each operator. A copy of this document should be kept on file with the bank where business is conducted.
- (iii) Production records of crops and livestock.

Maintaining records for a number of years makes it easier to arrive at a fair basis for a person starting in the farm business. Farm records provide knowledge about the average income and expenditures under the previous plan of operation and management. They also give the value of farm capital used. This information makes it possible to determine if and how the son can be accommodated on the farm.

Responsibility for keeping farm records should be assigned to one individual when setting up a farm business arrangement. Book-keeping tends to be neglected when left to everyone. Typically, it is wise to have the son keep the business records. This helps familiarize him with the business and develops his organizational talents. The father should also keep himself fully informed of business conditions at all times in order to recognize problems and to assist in making wise decisions.

### ALTERNATIVE FORMS OF BUSINESS ORGANIZATION

This section of the report describes the basic types of business organization, discusses the legal aspects of each and compares the utility of each.

The three basic types of organization are sole proprietorships, partnerships and corporations.<sup>1/</sup> Most farms in Ontario are organized as sole proprietorships. The 1971 census of agriculture indicated that 90 percent of the farms in the Province fall into this category. Another eight percent of the farm businesses were partnerships and two percent were incorporated.

A critical part of any business is the form of organization used. The form provides the economic and managerial framework of the farm business. The operator(s) obtains and controls the assets within this framework. The form of organization may affect the continuity of the business, the risk the operator undertakes, the scope of operation and freedom of action, the resources available, and of no small importance, the cost of doing business. Therefore, any business operation is dependent upon the form used.

The farm business, like any other business, can be organized into any of the three basic forms. These types of business organization can be modified and combined in various ways. For example, two sole proprietorships may establish a business agreement for joint ownership of some assets

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<sup>1/</sup> It is possible to set up a cooperative type of business organization but most farmer cooperatives are organized only for part of a business such as a machinery cooperative or buying cooperative. Most complete cooperatives would be similar to partnerships with respect to legal and tax implications.

or joint operation of some enterprises, or the corporate form may be used for part of a business with some of the assets owned by individuals and rented to the corporation or two corporations enter into a joint arrangement for one enterprise. More and more farm operators are reviewing their current legal business organization and investigating the advantages and disadvantages of the three major organization forms described below.

#### SOLE PROPRIETORSHIP

Sole proprietorship or individual proprietorship is the simplest form of business organization. Under this form an individual owns the assets, manages the business, assumes all the risks, obtains all the profits and bears all the losses. The Ontario farmer has traditionally operated a sole proprietorship, owning and managing his own farm as he sees fit. This type of organization is the easiest structure to begin and end. An individual can start a business with a minimum of organizational cost and wind it up without special legal costs related to the business organization. The business ceases to exist under that name when the individual dies except for regulations involved with settling of estates.

Ownership of a sole proprietorship business should not be confused with ownership of all the farm assets. An individual farm proprietorship may exist on a rented farm and with all other assets used either rented or purchased with borrowed funds. The factor that makes a business a sole proprietorship is that one person is solely responsible for the business. That person is the boss and the decisions, policies and goals rest in that individual. Laws relating to business actions are those which govern the legal rights and obligations of an individual. Since the sole



proprietorship is the oldest and most widespread legal structure these laws are clearly defined for relationships between the sole owner, his agents, his creditors and others with whom he has business dealings.

The sole proprietor receives the rewards of good management and labour directly. The proprietor can hire labour and the services of professional managers, lawyers, accountants and other specialists but the rewards or penalties resulting from their actions accrue to the owner.

The sole proprietorship has flexibility, the operator can make decisions quickly without being required to consult others. Theoretically this allows the greatest amount of managerial flexibility, but may be a disadvantage if the owner makes decisions without obtaining adequate knowledge or consistently delays decisions. Other forms of organization often involve several manager owners who divide up managerial responsibility and are collectively responsible for major policy decisions.

#### LEGAL ASPECTS OF SOLE PROPRIETORSHIPS

In a single proprietorship the capital for business operations is obtained from savings or inheritances, by borrowing, by purchasing on credit or by reinvesting profits. Thus the individual is responsible for acquiring the capital needs of the business and is liable for all the debts of the business. In this form of business organization, the individual's personal assets and farm assets are lumped together. This lumping together of all assets is especially significant since liabilities incurred by the business either through business loans or any other legal liability created by accident or negligence have claims against personal assets. Similarly any personal liabilities against the individual can make claims against business-related assets.

Members of the family may be hired by the sole proprietor in some kind of employer-employee relationship so that children are paid wages for services to the business. The sole proprietor may wish to form some type of business agreement with children over 18 years of age who continue farming. When this situation arises other forms of business such as a partnership or a corporation may be organized but many farmers' sons prefer to start a separate sole proprietorship. The two businesses then may enter into some form of business agreement whereby they share the use of some of their resources or operate some enterprises jointly.

#### TAX IMPLICATIONS OF SOLE PROPRIETORSHIP

The net income of the sole proprietorship is reported to the tax department as the business income of the owner and taxed at personal rates. If the spouse of the sole proprietor receives wages for business labour and management services these wages cannot be reported and taxed separately. The business net income includes any wages paid to both spouses and must be declared on one tax statement, the owner's.

Assets owned by a sole proprietorship will be subject to taxes on any capital gain when sold or transferred. The owner computes the capital gains and losses when assets are sold and reports the appropriate taxable income on his tax statement for that year. A special rollover provision allows an owner to transfer farm assets to a spouse or to a child or children and defer the assessment of the capital gains tax. The assets transferred must be used by the owner or his or her family for farming immediately prior to the transfer and continue to be used by the recipient(s) for farming purposes. The rollover provision can be used for transfers of assets made by sale or gift while the owner is alive or by bequest through

a will upon death. Essentially the transfer is made at the owner's tax base cost and the recipient assumes the tax liability on the accrued capital gain. Transfers made to children by gift may be subject to Ontario gift taxes.

### PARTNERSHIPS

A partnership is a voluntary association of two or more persons to carry on a business for profit. This does not mean that all the assets used in the business must be co-owned, but that the business as a business enterprise be owned by partners. The profits and losses of the business are shared by the partners. Partnerships are popular with farmers for the following reasons:

- (a) The opportunity to share operations between generations.
- (b) The pooling of limited or unique resources.
- (c) To facilitate the transfer of farm business from parents to children.
- (d) The splitting of income for living and/or tax purposes.

A partnership is created by an oral or a written agreement. It is the simplest form of business for two or more persons to start and terminate. It has the same flexibility of purpose and operation as a sole proprietorship and needs no governmental approval to be started. It may be terminated by agreement between the partners or by the operation of law. Dissolution by agreement depends on the partnership agreement if it includes a fixed term or by one of the partners giving notice of intention to the other partners. Dissolution by the operation of law occurs in the event of death, or bankruptcy.

A partnership may be either a general or limited partnership. In

a general partnership all partners share in management, authority and responsibility. Each partner is liable for the business actions of all other partner(s). In a limited partnership the senior partner(s) provides the management and accepts responsibility for full business liability. Limited partners are liable for debts and/or other obligations of the partnership only to the extent of their investment in the business and they do not participate in the active management of the business.

Partnerships operate under the Partnership Act of Ontario which defines partnerships as a relationship between persons carrying on business in common with a view to profits. The Act indicates that co-ownership of property or the sharing of gross returns do not in themselves create a partnership. The sharing of profits provides stronger but not exclusive proof of a partnership. Thus, the laws governing partnerships do not set out specific rules for the formation of partnership and therefore any business operated jointly by more than one person and not a corporation may be interpreted by the courts and/or the tax department as being a partnership. Some of the characteristics of a business that may indicate a partnership are as follows:

- (1) More than one person participating in management decisions.
- (2) Jointly owned assets.
- (3) Sharing of profits and losses.
- (4) Operating under a firm name.
- (5) Using a joint bank account for business transactions.
- (6) Using a single set of business records.

A business agreement between individuals might have one or more of the above characteristics and not necessarily be a partnership. No one factor is controlling. All may be applied to a particular arrangement

to determine whether in sum it is a partnership.

#### LEGAL ASPECTS OF PARTNERSHIPS

If a partnership exists the legal aspects of the business would be the following: Unless otherwise specified in the agreement, legally, each partner has an equal voice in the management and a majority of the partners control business decisions.

The partnership owns the partnership assets and partners own a partnership interests in those assets. Partnership interests increase or decrease as net assets of the partnership increase or decrease. The profits and losses of the partnership are divided in accordance with the agreement. Partners do not normally draw compensation for management and labour services and any "wages" received by partners should be treated as advances on their share of profits. The share of profits specified in the agreement does not have to be based on partnership interests but should consider the total contribution made by each partner in the form of labour, capital and management. Each partner's partnership interest will change each year by that person's share of profits less withdrawals adjusted for any new capital invested in the partnership by that partner. Any capital gains and losses accruing to partnership assets will be shared by partners according to the profit sharing agreement. Finally, partners may own assets outside the partnership which are rented or leased by the partnership for business purposes.

In a general partnership each general partner is fully responsible for all the debts of the partnership. Carried to its conclusion, this means that each general partner is liable for the wrongful acts of a co-partner if the co-partner is doing partnership business. Contrary to



popular belief, this liability of a partner does not extend to the personal debts and obligations of the other partner(s). If a partner's personal assets are not sufficient to meet personal debts, the creditor may take legal action to require the partnership to pay the debtor-partner's share of the partnership net income to the creditor until the debt is discharged, but the partnership would not normally be forced to liquidate assets to discharge the debt. If a limited partnership is formed all limited partners are liable only to the extent of their investment in the business.

#### TAX IMPLICATIONS OF PARTNERSHIPS

A partnership must have its own financial records, especially for tax purposes. The partnership net income is not taxed directly but a statement of partnership net income is prepared and included in the income tax statement filed by each partner. Then each partner declares his share of that net income on his individual tax statement and pays taxes at the individual tax rates.

Tax regulations in Canada include special rollover provisions which apply to partnership assets, the tax base value of partners' partnership interests and the timing of the payment of taxes on the capital gains accruing to those assets. In general, a person can roll assets into a partnership and defer payment of capital gains taxes if that person's partnership interest is valued at the current adjusted cost base of those assets. Similarly, a partner's partnership interest represented by partnership assets can be rolled out of a partnership and if these assets continue to be used by that person in a sole proprietorship or new partnership,

the tax on capital gains can be deferred. Also, partnership assets can be rolled into a corporation under similar provisions if the partners own 80% of the voting shares of the subsequent corporation and the partners accept capital considerations at the same values as their partnership interests.<sup>1</sup>

The capital gains tax is payable on capital gains realized when a partnership sells assets to outsiders or when a partnership is dissolved and assets dispersed and/or partners retire or cease business. Even in these latter two cases, a partner can transfer his or her partnership interest to a child or children by sale or gift when alive or by bequest through a will, and if the recipient continues to use those assets in farming the capital gains tax may be deferred. In all of the above cases the new business or owner of the assets transferred assumes the deferred capital gains tax liability. Also, in every case, the taxpayer or executors, if the transfer is through an estate, must elect to use the rollover provisions and file the appropriate forms with the tax department at the time of asset transfer. Finally, a taxpayer may elect to use a transfer value (up to fair market value of the asset) higher than the present adjusted cost base and thus pay at the time of the transfer, all or any part of the tax on accrued capital gains.

Husband and wife partnerships may be organized to operate a business. Both spouses should contribute both investment capital and labour to the business. The capital contributed by each should be obtained separately from each spouse's savings, gifts from others, or inheritances and not by

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This discussion of rollover provisions covers only a general outline of the tax regulations. Any person considering a transfer of assets is strongly advised to obtain professional services and to consult the tax department.

interspousal gifts. When these conditions are met the partnership net income can be divided according to the agreement. Each person can then make contributions to the Canada Pension Plan and Registered Retirement Savings Plans and file separate tax statements declaring his or her business earnings.

### CORPORATIONS

A corporation is an artificial entity formed to carry on business in its own name. Its legal rights and duties are distinct from those of its owners. This difference has meant that the farm corporation has features not found in other types of organization.

The owners of a corporation are shareholders who own shares in the net assets of the corporation; but, the assets and liabilities of the company are its own. Liability of the shareholders is limited to the paid portion of their shares in the company's capital stock. In return for capital contributions, shareholders are entitled to receive dividends that the directors of the company declare payable.

Shareholders do not exercise managership although they own the company. Authority of the shareholders is restricted to voting at the annual meeting or special meetings. Between these meetings a board of directors exercises control, on the shareholders behalf.

A corporation director is a trustee and agent elected at the annual shareholders' meeting to serve for a year on a board which manages the company's affairs. The board of directors supervises the actions and performance of management, decide matters of policy and leave implementation to management. All major questions affecting the company in a broad way should be brought before the board for consideration. The board can make

decisions binding the company and is supreme, subject only to the shareholders. While the directors have complete responsibility for company management, many of their acts on behalf of the company must be submitted to a meeting of shareholders for approval.

Ownership of a corporation is divided into individual units called shares. At the time of incorporation stocks (shares in the company) are issued in exchange for property or cash contributed to the corporation. Thus, stocks represent the subscribed money value of the shareholders' capital. The shareholder is not liable for any further contribution beyond the amount for which he has subscribed.

Two classes of shares may be issued by a corporation: common and preferred.

1) COMMON STOCK: Common stock represent the "residual" ownership of the company after all superior claims have been satisfied. Holders of common stock share pro rata in the net profits of the business after the stipulated dividend, if any, has been paid on preferred stock.

2) PREFERRED STOCK: Preferred stock possesses the same rights and privileges as common stock unless stated otherwise. Additionally it receives preference either as to receipt of dividends and priority to claims with respect to assets in event of terminating the business.

Within each class several variations in these stocks are possible. The specifics of a stock depend on the problems and objectives of the particular firm. The nature and conditions attached to the corporation's stocks are listed in its charter and by-laws.

The voting privileges of a stock are quite important. Both common and preferred stock can be divided into voting and non-voting sub classes.

All shares carry equal voting rights unless specified otherwise. Voting rights are usually reserved for common stock but occasionally preferred stock has voting rights too. Retaining control in common stock is desirable because its holders only have residual claim in the company.

Stock may have a Par Value or be termed No Par Value. Par Value means that the share have a stated or face value as authorized by the letters of patent. The Par Value may be \$1.00 or any other convenient amount, not exceeding \$100.00 under the provisions of the Federal Statute. No Par Value stocks have no fixed value. Each stock represents ownership of a certain fraction of the company's net assets.

#### LEGAL ASPECTS OF CORPORATIONS

Once a corporation is formed it is a separate legal entity, separate and distinct from the shareholders who own it, from the individuals who manage it, or from its employees. It is created by the Provincial or Federal laws and organized for the purpose of carrying on a business for profit. Most private farm corporations are organized under the Ontario Laws. Companies organized under federal law are usually large scale public corporations. The corporation, as a separate "legal person" apart from the shareholders, has most of the legal rights and duties of an individual. It can make contracts, transact business, hold property, sue, and be sued.

To start a corporation two legal documents are necessary: the Memorandum of Agreement and Letters Patent. Every corporation should have a set of bylaws; a constitution providing the guiding rules for running the business. Once in operation, a corporation needs to keep the regular financial accounts of any business plus a number of special records because of its peculiar capital and managerial structure. These special records



include: a copy of letters patent, a list of past and present shareholders, a list of past and present directors, a register of stock transactions, and minutes of director and shareholder meetings.

A private corporation in Ontario must have at least one director. Directors and shareholders must hold meetings. Directors must exercise their powers as agents and trustees. Shareholders must meet at least annually to: appoint auditors for the coming year, perhaps approve declaration and payment of dividends, approve bylaws passed by the board in the preceding year and vote on questions under consideration.

Most farm corporations are owned by a small group of shareholders; typically the farmer, members of his family, and possibly several non-related persons.<sup>1/</sup> The shareholders usually elect themselves as directors of the company and then hire themselves as officers in charge of managing the company. The board of directors becomes a mere formality since the owners are intimately involved in management. As a result, day to day operations of the farm change little. Business activities change to the extent that greater regulation requires more complex book-keeping; purchases, expenditures, and sales are carried on in the company name; and taxes are paid by the corporation.

The importance of running a farm corporation in a clearly defined and business-like manner cannot be overemphasized. The formalities should be observed, and the statutory rules followed.

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This can easily happen in a closely held corporation where ownership and management rest in the hands of the same people. Separation of the duties and activities of the owners and managers is important.

An important characteristic of the corporation is the limited liability of the shareholders for the acts and obligations of the corporation. This characteristic is often the main reason the corporate structure is selected. However, limited liability is of benefit only to the extent the shareholder has other assets not included in the corporation. If a farmer transfers all his assets to the farm corporation, limited liability is nearly meaningless. If a shareholder is liable for a debt incurred completely from a personal matter, the creditor may obtain the shareholder's stock to satisfy the debt, but not be able to reach the corporate assets. This means the corporation, the farm business, will remain intact and in operation.

#### TAX IMPLICATIONS OF CORPORATIONS

When a corporation is set up, the corporation becomes the "farmer" and the farmer and other family members who work for the business, become employees. As a separate taxpayer, the corporation is entitled to deduct as business expenses all salaries, wages and benefits paid to those employees. The net profit of the corporation is taxed at corporate rates which for most farms in Ontario in 1978 will be at the Small Business rate of 24%. Employees will pay taxes on their salaries, and wages plus dividends and other income received at individual personal rates. This means that all family members working for the business have separate incomes for taxation purposes and can receive other compensation in the form of benefits such as Canada Pension Plan, Unemployment Insurance, and contribute to Registered Retirement Savings Plans, Pension funds etc. which can be used as tax deferral programs.

Special regulations regarding dividends paid to Canadian taxpayers by Canadian corporations allow shareholders to limit the tax paid to a maximum of 24% on salary plus dividends of up to \$40,000 total income per person. If this amount of money was all received as business income from a sole proprietorship or partnership, the marginal tax rate would exceed 24% when individual family farm business earnings are more than \$10,000 per year (assuming no splitting of income between spouses and personal exemptions of about \$5,000 for married couples plus children). However, some of the tax reduction possible, by having earnings taxed at the small business corporation rate rather than the rate for individual incomes, may be offset by higher business costs of the corporation. These extra costs would be associated with the corporation requirements for more detailed records and more time spent by family members in record keeping and business meetings. For this reason the tax advantage of corporations should only be considered as an important factor when average net earnings of the business per family exceed \$15,000 per year.

Assets can be rolled into corporations at the individual's tax base or tax base of partnership interests and defer assessment of capital gains if the individuals or partners own 80% of the voting shares of the new corporation. The corporation assumes the capital gains tax liability on the accrued capital gain. Shares in private farm corporations can be transferred from parents to children using the same parent to child rollover provision available when individual farm assets are transferred. Farm corporations are also treated the same as individual farm businesses for tax options related specifically to farming except for five year block averaging, but corporations can carry forward business losses to offset profits in subsequent years.

### COMPARING BUSINESS ORGANIZATION

The form of business organization a farmer uses will not guarantee the success or failure of the business, but will have an appreciable effect on the operation and transfer of the farm business. This section of the report looks at the characteristics and legal consequences flowing from each type of business organization. Since no form of organization is tailor made to suit the circumstances and nature of every farm, the type used should be based upon weighting the relative importance of certain needs against the limitations of each type of organization. The discussion below presents the major factors that should be considered in this decision.

#### LIABILITY OF OWNERS

A business may be liable for personal injury and property damage to a third party resulting from the business. This is called "tort" and encompasses a miscellaneous group of civil wrongs. Any business should carry liability insurance to cover these. The second is breach of contractual obligations resulting from the actions of management.

The sole proprietor or general partner is personally liable for all the debts of his business including all acts of agents or partners done in the course of business. This means that personal investment of the owner are at risk if obligations of the business exceed the capital in it. A disastrous farming experience may completely wipe out a farmer.

Limited partners and corporate shareholders appear to be in a better position. They are only liable to the extent of their investment in the business. If the business goes bankrupt, personal or real property of the owners cannot be seized to satisfy the creditors' claims.

The corporate form however, does not guarantee limited liability. While a shareholder might not be liable; an employee, officer or director may be held personally liable for wrongful acts committed while performing business duties. A farmer who is both a manager and owner may find himself subject to unlimited liability. A shareholder's liability might also exceed his business investment when he assumes personal liability for debt obligations of the corporation. This frequently happens when his personal guarantee by co-signing a note is required to obtain a loan from a bank or other major creditor. Co-signing of notes is frequently required with small family corporations, and the advantage of limited liability is lost by the individual(s) who co-signs.

The value and importance of limited liability will vary from one farm situation to another. It does not make much difference if most of an individual's assets are in the farm corporation. It is useful when an active farm operator has considerable outside investments which he wishes to protect. It is also useful when a farmer retires but wants to keep a portion of his assets in the business. He is able to protect his personal property while maintaining an interest in the business.

#### CONTINUITY OF EXISTENCE

Continuity of existence is another factor to consider when choosing a form or organization. It affects both the capital structure of the farm and the ability to pass it on as a going concern.

Sole proprietorship and most partnerships are under no legal time limit, but they are not perpetual and are limited to the lifetime of the



proprietor or partners. Withdrawal or death of a party automatically terminates that business. Many times settlement of the estate involves dissolution of the business, division of the assets among the heirs -- sometimes possible only through liquidation.

To provide equitable treatment of heirs and keep the farm together, a market for the farm should be created before the owner's death. The best solution is sale of the farm to the operating heir through a binding buy - and - sell agreement.<sup>1/</sup> This ensures that the heirs receive an equitable share in the estate while the son receives a going concern. Also, in a partnership, the partners can write into the agreement procedures whereby the surviving partner(s) purchase the partnership interest.

A corporation exists as long as it continues to meet statutory requirements and its shareholders want to keep it operating. Theoretically, the existence of the corporation and continuity of operations is not affected by the death of a stockholder. When a shareholder dies his shares become part of his estate and can be passed on through a will, laws of descent, or purchase by the remaining shareholders. Only the stocks of the corporation go through probate: the business continues to operate without having specific items of property tied up in probate court. In practice, the death of a principal shareholder can have a serious impact.

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The operating heir (son) would sign a binding agreement to buy the complete farm from father. He would then take out a life insurance policy on his father, pay the premiums and be beneficiary of the policy. On father's death he would collect the insurance proceeds and use them to pay for father's share of the farm. Similar arrangement can be made to use insurance policies to purchase partnership interests or corporation shares.

A 'one-man' business can be in serious trouble in the absence of adequate planning. The cost of transferring shares can be very high and complex. Moreover a capable manager may not be available to take over operations. A properly organized corporation will gradually transfer stock if business continuity is desired. The transfer of stock provides a progressive shift in ownership and management from one generation to the next.

Ultimately, business continuity depends more on the willingness of family members to carry on the business than the type of organization. The business will likely be dissolved if there are no family members wanting to carry on the farm no matter what type of organization is used.

#### TRANSFER OF OWNERSHIP

The type of organization affects the ease with which ownership interest can be transferred. Ownership in the sole proprietorship is hardest to transfer, that of the corporation is easiest.

Ownership interest in a sole proprietorship is transferred only by inheritance, sale or gift of assets. This transferral process is often inadequate when trying to pass on the farm as a going concern unless it is part of a business agreement. A business agreement allows father to pass on ownership of assets while maintaining certain property rights that may be necessary for viable operation of the farm.

Multi-owner business organization encourages and facilitates the transfer of ownership interest. Both partnership and incorporation allow a fraction of the business to be passed on rather than individual assets. This is especially important when a family is large and assets might have to be split if family members are to be treated equitably. In such cases

assets are often liquidated, the proceeds may be less than market value and the farm loses an asset.

The transfer of a partnership interest is comparatively easy when the written arrangement contains clauses providing for it. Often this is not the case.

The shares of stock in the corporate provide the easiest and most convenient way to transfer ownership shares of stock in the corporation. The transfer of ownership interest is easily made because stocks can be in small units, are easily divisible, and do not disrupt continuity of the business because they are not tied to any specific assets of the business. Incorporation is also useful in other ways. Father's equity in the farm can be frozen by issuing par-value preferred stocks for his contribution while the son acquires no par-value common stock which can increase the value as the business grows. Orderly transfer of shares can keep a son interested in the farm and let him know where he stands financially in the farm business.

A problem with incorporation is that once capital is committed to the company, shareholders have difficulty withdrawing it. Company law says that the capital of a company must be clearly defined and remain intact for the benefit of creditors. Share capital can only be withdrawn by a special resolution of the shareholders. The shareholder who tries to sell his stock in a private corporation is likely to find himself in a limited market restricted by the transfer provisions of the company. Articles of incorporation should detail the method for buying out shareholders wanting to sell.

In most cases, the costs associated with ownership of assets through a corporation exceed those of other forms of business. Capital gains on assets owned by the sole proprietor or partner are subject to more generous treatment than ownership interest in the corporation.

#### MANAGERIAL CONTROL

The sole proprietor owns the assets, manages them and bears complete responsibility. He is completely independent to do what he wants but he must bear the consequences of his actions. In a partnership neither partner has the freedom to be his own boss. Managerial responsibility is held jointly although partners may divide it. When major decisions are made, there should be joint consultation. Otherwise, one or more partners may be disillusioned by the domination of a stronger partner.

The management and control of a corporation is more structured and formal than that of other types of organization. This formality is required because of the separation of financial ownership from management. Owners of capital are not always in direct control of their investment; the risk-takers are not the risk makers. Individual shareholders have no active voice in management. Management is centralized in the authority of the board of directors. Shareholders only exercise control through the power to elect the board of directors. In many closely-held farm corporations this distinction is not very important. Father and son are often owners, directors and managers of the farm.

A desirable feature of a corporation is that it enables a father to pass on ownership in the business while maintaining control. Father could maintain control of the corporation by holding a majority of voting

stock and limit the growth of his estate by holding preferred stock. A caution is necessary. A court has found that a father maintained substantial control over a family farm through holding five-sixths of the voting (preferred) shares. The father could have stripped the company of its surplus although he did not. The court, therefore, increased the value of his shares by the total surplus of the company. This increased the size of the father's estate liable for succession duties. This problem may be minimized by dividing voting rights between father and son. Father would hold veto power but not control of the company.

The corporate form can create problems for a minority shareholder. If he is in a weak position he may be forced off the farm (i.e. if only one of three children is farming on the parent's death, he may be forced off the farm by the other two when voting power is equally distributed). He may not be unable to take his share out of the farm assets or to force payment of dividends on his shares. He may be unable to stop majority shareholders from taking profits out of the business as salaries. The market for his shares is limited. Dissident shareholders however, can not interfere with the company's policies and management except by voting at shareholder meetings. This provides for smoother operations than partnerships where control and management are always dependent on agreement between the partners.

Corporate bylaws should contain provisions protecting minority shareholders. Regulating the sale and transfer of shares can help maintain family control (i.e. any stockholder wishing to sell his shares can be required to first offer them to the family) but there should also be provisions protecting those who wish to sell their shares (i.e. provide alternatives such as sell-options).

### RESOURCE ACQUISITION

No particular type of organization has an advantage, over the others, if the owner hopes to supply all the resources needed. The type of organization, however, is important when a business turns to the outside for resources.

Inadequate capital for financing current operations and expansion is a factor often limiting efficient operation of the farm. The amount of capital financial institutions will lend to a farmer depends upon the capacity of his business to repay the loan, the collateral the farmer provides as security for the loan, the financial condition of the business when the loan is made and the farmer's character. Credit will be available if these factors are favorable.

The sole proprietorship is limited by the individual's sources in acquisition of capital. The major sources of capital are earnings from operations and debt from lending institutions. Capital availability is inevitably limited by the entrepreneurial abilities of the proprietor and other personal sources.

Other types of organization favor the acquisition of capital because they allow two or more parties to pool their resources. The result is a business possibly with more equity capital, more efficient farm operation and the potential to justify more debt than if parties worked separately.

Farm business agreements provide a starting farmer with the experience necessary to run a farm and may allow him to acquire assets. When he needs a loan he can show that he has the necessary farming experience and knows how to work in a business-like manner.

Partnership enables greater pooling of capital. Moreover, the

unlimited liability of general partners provides greater security for lenders. A limited partnership can be attractive to the outside investor who does not want to participate in management and wants to limit his liability. But the limited partner is in a poor position to protect his investment. He can offer advice but is unable to exercise any managerial authority.

Bringing together all the capital under a single, unified control in the corporation may attract even more capital and improve the credit status. Limited liability of the corporation means that the credit of the corporation is not impaired by the liabilities of individual shareholders. Perpetual operation is assured because the business does not need to be organized and refinanced every time an owner dies. Finally, ownership through shares allows pooling of assets from various sources.

The family farm corporation is useful because of its ability to induce members of the family to invest in the farm. The corporate structure can help retain capital in the business by providing for sale of stock rather than sale of business assets. Non-farm heirs may be encouraged to maintain ownership in agriculture and keep their inherited capital in the farm if they receive a reasonable return. When investment is maintained involuntarily in the business, disagreements may arise over such things as dividends, expansion and management. The articles of incorporation should provide an avenue of escape for those who want to sell their shares in the corporation.

An outside businessman may want to become associated with a farm but may not want to assume management responsibility. A corporation or limited partnership allows him to invest in the modernization or expansion of a

going concern that is already under good management. His liability is limited, he has some say in management and he is able to hold ownership through a class of share capital or partnership interest that suits his preferences.

Supplying mortgage money or other forms of credit may be the best way to investing in farming for some individuals. Creditors are entitled to payment of principal and interest on a regular basis. The form of organization of the business may not affect the investment decision of these individuals.

There are also differences between types of organizations in terms of acquiring and maintaining competent labor and managerial personnel. More complex and more highly capitalized businesses find management an extremely critical factor. Managerial input is usually improved when more than one person is involved. Pooling managerial ability and experience, specialization of tasks, provision of "back-up" management, ability to attract better personnel and greater continuity of management are all factors leading to this improvement. On the other hand, the more people involved in management the more likely personal conflicts. As farms increase in size and complexity, the partnership and corporate farms which involve several persons will likely increase the managerial input into the business.

#### COMPLEXITY AND EXPENSE

The complexity and expense of each type of organization should be considered when selecting an organizational form. The greatest advantage of sole proprietorship is the ease of establishment, operation and termination.



Other types of organization are more complex. Moreover, their scope of operations is limited by the terms of the written arrangement or corporate charter.

Business agreements and partnerships require legal documentation and extra financial records. Tax accounting and equitable division of income can be very complex, especially when the resources contributed by each party change every year. One slip-up or alteration in procedure can lead to an entirely inappropriate division of income.

A corporation can simplify the tedious problem of annual division of income through payment of stock dividends rather than division by the terms of an agreement. However, incorporation of a limited liability company is usually more costly than forming a business agreement or partnership. The corporation also faces more "red tape." Permission from the government is required to form a corporation. The business must pay special filing fees and taxes for the privilege of being a corporation.<sup>1/</sup> It must hold formal meetings and keep special records. Many of the special features available through incorporation, when used, add to the cost and complexity of operation.

In setting up any kind of business arrangement other than sole proprietorship, provisions should be made for disengagement and dissolution. This may add to the immediate cost of creation and requires additional record keeping but it is worthwhile in the long run. Even when an arrangement starts under the best of circumstances the parties may eventually find

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One saving grace is that a company incorporated under the laws of the Province of Ontario is not required to publish financial statements if it has not issued securities to the public.

that they can no longer work together; their objectives may change or personalities may conflict when they work together. The ability to dismantle the arrangement without further straining personal relations and equitable treatment of parties is of inestimable value.

A large part of the complexity and expense of the different types of organization stems from their tax treatment. The tax structure has become so complicated and subject to so many changes that it is difficult to make a wise choice of organization. In all but very simple cases legal counsel should be sought when trying to determine the organizational form that will minimize taxes. For this reason tax regulations affecting income and asset transfer were only briefly reviewed here.

All profits of the sole proprietorship and partnership are taxed at the personal rate of 8 to 62 percent of taxable income. Although the partnership is a separate tax entity, income is not taxed at the business level. The partnership acts as a conduit transferring income from the business to the individual partners in the same form as received or earned. Income is then taxed in the partners' hands at personal rates.

The corporate form makes the overall tax position of the business more complicated but it also open up new avenues. Corporation income is taxed at the corporate level, corporate losses can not be used by individual shareholders, and income can not be averaged but losses can be carried forward. On the other hand a corporation is able to provide employees with fringe benefits that are tax deductible whereas similar outlays can not be used for tax advantages in sole proprietorship. A real advantage is that the directors can shift income among the corporation itself as retained earnings or reinvestment, its employees as salaries and wages

and, its shareholders or owners as individuals. The guiding principle in this allocation decision is that income tax liabilities are minimized when marginal tax rates of each of the taxpayers are equated. This principle is complicated by the fact that some profits must be left in the business, earnings paid out to the shareholder as dividends may be taxed a second time but special tax treatment of dividends from Canadian controlled corporations reduces the effective tax rate on individual's dividend earnings.

Gift taxes and succession duties are the same for all types of organizations when assets are transferred. Capital gains rollover provisions of transfers to children of individually owned farm assets, farm corporation shares and partnership interests in farm assets are available to Canadian taxpayers.

#### CONSTRUCTING AN ARRANGEMENT

A suitable business arrangement facilitates the operation and transfer of the farm. Constructing one should not be taken lightly or done in haste. It is an important process that may involve many thousands of dollars and several people's future. The decision affects:

- i) present owner's security - need to provide retirement income for parents who usually have all their savings invested in the farm.
- ii) career potential of new owners - want to leave the farm productively intact for the new generation.
- iii) overall family goodwill - financial consideration needs to be accorded to members of the family who contributed to the

success of the farm business but have withdrawn from it at this point.

Thus, decisions regarding business arrangements must be made wisely.

The form of organization will provide the managerial and economic framework for the arrangement. The one best suited to a particular farm can only be determined after considering all the circumstances peculiar to the farm -- the size and nature of the enterprises, and the objectives of present and future owners. There is no need to stay with one form of organization. Circumstances change over time. Business arrangements may be better if the business evolves through different forms of organization as the son matures, and acquires managerial expertise and capital.

#### WHEN TO DO IT

Activities giving a young person experience and training in farming practices, in making management decisions and in handling finances should be started as soon as possible. Arrangements are usually started and revised at "crossroads" in the farm family's life. Typical crossroads are when: the son starts farming; the son marries; operations undergo major expansion; enterprises are changed; there is a sudden awareness of the need to plan the estate; the family is dissatisfied with the present structure of the farm business; and father retires. A business arrangement should be made while father and mother are still operating the farm. At this time, flexibility in making choices is greatest since the parents are still active and able to pass on a going concern.

Father and son should always keep in mind that a formal business agreement is in order if they are working together. The longer they work

together without an agreement, the harder it will be to decide on a mutually satisfactory treatment when the time comes. The son's position with respect to the father's estate should be clarified early. Father may die suddenly leaving the son with no special claim on the farm assets. The son may be near retirement age if he waits until father dies. The uneasiness and uncertainty that persist when there is no formal agreement may make the son lose interest in the home farm and he may even leave farming altogether.

#### HOW TO DO IT

There are five major steps in constructing a business arrangement as follows: begin communication between parties; assess the objectives and net worth of each party; appraise alternative arrangements; pretest the selected arrangement; and, formalize the finalized arrangement.

Communication is the key to planning a successful business arrangement. However, communication between father and son tends to be notoriously poor. Many fathers do not take the time to discuss the farm business with their sons. They may like to have the son as a business partner but do not want to force the issue. Few sons, on the other hand, muster up the courage to say "I'd like to talk about my future on the farm." Father, son and the rest of the family need to overcome their reluctance to discussing the family farm situation openly and frankly. Use of third parties such as agricultural representatives, and professional advisors, can be helpful when the family has trouble broaching the subject.

Once the communication stage has been reached, father and son must examine their present situation carefully. A written statement of the objectives and net worth of both parties can be very helpful to the family and professional advisors.

The foundation of any business arrangement is the clearest possible definition of family and business objectives. Often neither father nor son knows the goals and aspirations of the other. Little differences here usually make big differences in the final analysis. Each party considering an arrangement should list family goals and objectives and then outline a general description of business and family situation. This should include:

- brief description of type of business arrangement presently being used.
- description of farm business: size, efficiency, profitability and financial soundness.
- list of family members giving; age, education, marital status, employment and comments on special considerations.

With this material in written form, the family should be able to determine if the farm satisfies the requirements presented at the beginning of this report. If so, a successful business arrangement is possible and the family can go on to the next step and seek professional advice.

The family should discuss alternative forms of business organization with professional counsel.

The choice of business organization is important and should be made only after analyzing the advantage and disadvantages of various alternatives based on family objectives and resources. The weighting given to each of the factors when selecting an organizational form differs depending upon the motivations of the family. No matter what the motivations, the arrangement should provide all eventualities -- not only facilitating farm operation and transfer but also disengagement and separation if necessary.

Once the business organization has been selected, decisions can be made regarding the finer details of the arrangement: who will contribute capital and labor; how will costs be shared; how will income be shared; how long will the arrangement last; what are the provisions on disengagement.

Any proposed arrangement should be tested to determine if the financial terms are feasible before the arrangement takes effect. This may be done by estimating the results for a typical year under the proposed plan. It will involve budgeting, cash flow planning and detailed analysis. This forces parties to consider all phases of the proposed operational and business relationship before the arrangement is finalized. If estimated results reveal disappointments, adjustments to the plan are called for.

Once tested, the arrangement should be carefully documented to minimize taxes and avoid family pitfalls.

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