Collins Barrow
Chartered Accountants

FARM ALERT

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USING PARTNERSHIPS IN YOUR FARMING BUSINESS

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The last two issues of the Collins Barrow Farm Alert have discussed the benefits and issues around incorporating your farming business. Another structure that can be used effectively is a farm partnership. This article will outline how a partnership can be used as well as some tax planning opportunities that are available.

What is a Partnership?

It has been established that for a partnership to exist there must be a business carried on by two or more people with the intention to generate a profit. With this in mind a partnership can be made up of related or unrelated people. While corporations can also be partners, this article will focus on partnerships between individuals.

Setting up a Partnership

Once it has been determined that a partnership will be used the first step is to have a partnership agreement prepared. The partnership agreement identifies the partners, discusses how profits are to be allocated, governance and operations, what happens if a partner dies or leaves as well as a number of other issues. While it is common that taxpayers, particularly spouses, file income tax returns as a partnership without having a partnership agreement in place, the agreement helps deal with issues that may occur throughout the life of the partnership as well as help validate the partnership if questioned by Canada Revenue Agency (CRA).

If an individual has been farming for years as a sole proprietor and then decides to form a partnership, it is not as simple as just adding a new partner. An income tax election under section 97(2) of the Income Tax Act should be used in this case to transfer the farming assets of the individual into the partnership on a tax deferred basis. If this step is not done the individual with the farming assets could be viewed by CRA to have sold all their assets to the partnership at fair market value, a result which may not be a favorable one.

Prior to commencing operations and having assets transferred to it, the partnership should be registered for GST/HST.

Taxation of Partnerships

A partnership with at least one individual as a partner must have a December 31 year end for income tax purposes.

Net income is calculated at the partnership level and then split between the partners based on a pre-determined method of allocation. Various items such as capital cost allowance, allowance on eligible capital property and optional and mandatory inventory adjustments are claimed at the partnership level before the income is split.

For example, Mr. and Mrs. Jones have a farm partnership in which they split the income 60/40. Their revenue and expenses are as follows:

Income	$ 100,000
Expenses	(70,000)
Capital cost allowance	(15,000)
Net income	$ 15,000
Mr. Jones' share	$ 9,000
Mrs. Jones' share	6,000
	$ 15,000

There are certain expenses which should be considered when calculating your partnership income.

Salaries paid to the partners are not deductible as expenses in the partnership but rather would be considered distribution of the equity of the partnership.

Property taxes and mortgage interest on land held by one or more of the partners should not be expensed if the intention is to leave the land out of the partnership. A more effective approach would be for the partnership to rent the land from the individual partners. Care should be taken to record this rental income on a rental schedule on the partner's personal income tax return and deduct the property taxes and interest against that rental income. GST/HST would be required on this transaction if the individuals were registered.

It is possible for a partner to claim expenses against their partnership income after it has been allocated. These may be expenses that the individual partner paid for rather than being paid by the partnership.

CRA may challenge the allocation that is used so care should be taken to ensure that it is reasonable taking into account capital invested and work performed.

Treatment of a Partnership Interest

A partner is considered to own an interest in the partnership. This interest is considered to be a capital property for income tax purposes. When the partnership is a family farm partnership, the Income Tax Act allows some favorable treatments of the partnership interest. These include the ability to sell the partnership interest, sheltering the gain with the capital gains deduction, or

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to use the farm rollover rules to transfer the partnership interest to a child or grandchild on a tax deferred basis.

For example, Mr. Smith and his son Ryan have a farm partnership. Mr. Smith has decided that he no longer wishes to farm while his son wishes to continue farming. Ryan's wife Jill is very involved in the farming operation. Because a daughter-in-law is considered to be a child for purposes of this section of the Income Tax Act, Mr. Smith can transfer his partnership interest to Jill on a tax deferred basis and the farm partnership will continue on with Ryan and Jill as the partners.

Incorporation of a Farm Partnership

An effective tax planning opportunity is available which enables partners in a farm partnership to sell their partnership interest to a corporation and use their capital gains deduction provided the partnership interest qualifies for the deduction.

Normally, when we think of the capital gains deduction, we think of its availability in the sale of farm land, farm quotas and to a lesser extent on the sale of shares in a farm corporation. Using the capital gains deduction to sell a partnership interest into a corporation can be an effective way to ultimately transfer farm assets such as inventory or equipment at their fair market value while taking back a tax free promissory note from the corporation.

Take for example the situation where Mr. and Mrs. Jones have a farm partnership with the following assets and liabilities at their fair market value:

Cattle	$ 800,000
Grain	300,000
Equipment	500,000
Total assets	$1,600,000
Less debt on equipment	100,000
Value of partnership	$1,500,000

Mr. and Mrs. Jones each have a partnership interest worth $750,000. They also have all of their capital gains deduction which is also $750,000. Mr. and Mrs. Jones can sell their partnership interests to a corporation offset the capital gain resulting from the sale with the capital gains deduction and take back promissory notes from the corporation of $750,000 each. As there is now only one partner (i.e. the corporation), the partnership ceases and as long as the corporation continues to carry on the farming business, the assets and liability then roll out into the corporation on a tax free basis, leaving them the ability to sell the cattle and grain at a low corporate tax rate and take out the after tax dollars without tax.

Use of a Farm Partnership to Qualify Land for the Capital Gains Deduction

Sometimes situations occur where farm land may not qualify for the capital gains deduction because the owner of the land has gross income from another source which exceeds his farming income. One way to make this land qualify is to set up a family farm partnership. The partnership, whose only source of income is farming income can then farm the land for two years enabling the land to qualify for the deduction provided all other rules are met.

Conclusion

The above article discusses farm partnerships in general as well as a few tax planning opportunities available. The concepts have been explained in general terms, so consider contacting your Collins Barrow advisor to assess your particular situation and determine how a farm partnership may help you. §

CAPITAL GAIN EXEMPTION/SHARECROPPING

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Every year we inevitably get asked whether or not a particular piece of farmland will qualify for the owner's capital gains exemption or whether the property is eligible to be transferred to a child at less than fair market value. And every year when we answer that question we run through a sort of checklist of things that could cause a piece of farmland to not qualify for the capital gains exemption or the transfer.

Before we get into the checklist let's take a minute to see what makes farmland eligible for the capital gains exemption and the transfer at less than fair market value and what the capital gains exemption is.

The lifetime capital gains exemption is an exemption from tax on the first $750,000 of capital gains realized on the sale of qualified farm or fishing property or the shares of a qualified farm or fishing corporation or a qualified farm or fishing partnership. The key point is that the property (or underlying property in a share or partnership situation) must meet the definition of "qualified farm property" as set out in section 110.6 of the Income Tax Act.

Basically, in order to be considered qualified farm property the property must be:

- Used in the course of carrying on the business of farming in Canada by the individual, or a spouse, child, or parent of the individual, throughout a period of at least 24 months immediately preceding the disposition **(the "holding period test")**
- In at least two years while the property was so owned, the gross revenue of such a person from the farming business carried on in Canada in which the property was principally used and in which such person was actively engaged on a regular and continuous basis must have exceeded the person's income from all other sources for the year **(the "gross revenue test")**

Any farmer who's chief source of income is farming will have little trouble fitting into these conditions however where someone has inherited farmland or purchased farmland from a third party, meeting this definition can sometimes be an issue.

When determining whether a certain property qualifies two of the common pitfalls we encounter are as a result of:

- The chain of ownership from parent to child has been broken, or
- The land was purchased from an arm's length person.

Chain of Ownership

In the definition you will note that there is a very specific group of people who can farm the property and the property will be considered qualified farm property. These people are the individual, or a spouse, child, or parent of the individual. The Canada Revenue Agency has indicated that any of the individuals listed in the definition can meet the tests for qualified farm property, which means that if your parent was a full time farmer or their parent, the land you inherited from your parent or grandparent will likely qualify.

However if the direct chain of ownership is broken, then you likely cannot rely on your parents years of ownership to qualify the property. Only your years of ownership and your farming activities will count. Where we see this happen is when Grandfather farmed a property. On the death of grandfather the property was divided between Father and Uncle. Uncle had no children and on his death you inherit Uncle's land. Even though Grandfather farmed that land as a full-time farmer, the direct chain of ownership between you and grandfather has been broken and therefore Grandfather's years of ownership cannot be used to qualify the property.

Arm's length person

With a purchase from an arm's length person, there is no parent or grandparent who farmed the land. Also keep in mind, your siblings are not one of the people listed in the definition of qualified farm property who can farm the land for you. In many instances we have seen siblings farming for their siblings, however that will not qualify the property.

In both cases you, individually, will need to meet the gross revenue and holding period tests. This can be problematic when you are not a full-time farmer.

Many people will turn to sharecrop agreements to try to meet the tests. While sharecrop agreements can help to bring farmland back onside, be aware that the Canada Revenue Agency has stated in paragraph 9 of IT-433R "The crop share received by a landlord in a sharecropping arrangement is considered to be rental income and not income from farming." "The above reference to "sharecropping arrangement" means an arrangement where a taxpayer or landlord receives from a tenant a share of crop in lieu of rent."

In a technical interpretation (2004-0068501E5), CRA states that "a taxpayer is considered to be carrying on a particular farming business when that person, to the extent that the particular circumstances of the particular farming operation allow, exercised general management and control of the overall farming operations, such as, for example, determining which fields will be planted, the type of crops to be seeded and the times for spraying and harvesting." "Ordinarily the person would be expected to contribute time, labour and attention to the business to a sufficient extent that such contributions would be determinant in the successful operation of the business."

If your sharecrop agreement is simply the receipt of a percentage of the crops, your arrangement will likely be viewed by the Canada Revenue Agency as a rental agreement. In order for your shareholder agreement to work it should clearly show that you are an active participant in the decision making relating to the farming operation carried out on your land and that you contributed in some way to the farm operation, whether that means you paid for part of the inputs, contributed labour to the operations, or both.

Of course there are many more factors that need to be considered when determining the status of a particular property and each situation will be unique. Please discuss your particular situation with your Collins Barrow advisor to determine whether your property does truly meet the definition of "qualified farm property" and if not, what can be done to remedy the problem. **§**

CORPORATE OWNED BUILDINGS ON LAND OWNED BY SHAREHOLDERS

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Many family farm corporations today seem to be building new barns on land that is owned by the shareholder or the corporation is constructing additions or making improvements to buildings that are owned by the shareholder and not the corporation. Under section 15(1) of the Income Tax Act, the shareholder or related party owner of the property could be taxed on the actual cost of the addition or the improvement to the property. When you review the Interpretation Bulletins, Case Law and the Income Tax Act it is pretty clear that where a corporation makes an improvement to property that is owned by the shareholder there could be a taxable benefit to the shareholder. This risk is somewhat reduced if the corporation has entered into a formal lease agreement to rent the property from the shareholder. Under section 15(1) a benefit conferred by a corporation can be included in the income of a person who at the time was not a shareholder. For example if a parent of the shareholder owns a property and an improvement is made to that property. The benefit will be determined based on a case by case situation.

In order to prevent a taxable benefit being imposed on the shareholder, there should be a proper lease in place between the shareholder and the Corporation for the land owned by the shareholder. The length of the lease should be negotiated to match the useful life of the building that the Corporation is building. For example if a hog barn or dairy barn was built the lease should approximate the expected life of the barn. For other types of buildings such as coverall buildings the shareholder may want a 10 year lease with an option of an additional 5 years. An option period in the lease would be recognized unless proof exists that it will not be exercised. The improvements to the property would then effectively be used up during the term of the lease (plus one option period, if applicable). The improvements can arguably therefore be ignored in calculating the benefit under section 15(1).

It is still possible that Canada Revenue Agency could assess a taxable benefit at the end of the lease term that would match the residual value of the building. CRA may require an appraisal of the property at the time that the lease has ended. Another consideration would be if the shareholder sells the land prior to the end of the lease. The lease should have a clause in it that if the shareholder sells the land prior to the end of the lease, the shareholder has an obligation to pay the Corporation the residual value of the buildings at the time the lease is terminated. Otherwise a taxable benefit could be assessed to the shareholder if the property is sold and no payment to the Corporation was made. Many times bare land and land with buildings on it are worth the same and therefore it could be argued that at the time of the sale there is no value of the building that would need to be paid back to the corporation.

When there is a taxable benefit the GST/HST also needs to be considered. Subsection 15(1.4) generally requires that an amount should be included in the shareholder's income which essentially equals the GST/HST that the shareholder would have paid had the shareholder purchased in the marketplace a property or service which results in a subsection 15(1) benefit or would have resulted in such a benefit had no payments been made to the corporation.

This is a very complicated and risky area and all of the various situations and options should be considered before one has a corporation build on land owned by the shareholder. We strongly recommend that clients contact their accountants to discuss the pros and cons of having their corporation build on shareholder land. §

Farm Alert is designed to highlight and summarize areas of interest to the legal profession in Canada. The contents herein are for the general interest of the reader. They are not intended, and should not be relied upon, as legal or professional advice.

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