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# Farm Business Arrangements in Manitoba



This publication may contain outdated information.



## Farm Business Arrangements in Manitoba

The surest way to reach a business goal is to plan on it. Successful Manitoba farmers are focused business people. They have clear, flexible, short and long term business plans – and they monitor their plans regularly.

Whether you're starting, growing or passing along your business, you need a solid business plan. And Manitoba Agriculture can help you build a plan for success.

Farm businesses are rapidly growing in size and complexity. The need for careful assessment of a farm operation and determination of which business arrangement best meets the needs of a farm is greater than ever. Understanding how a business arrangement is created, how it functions and the advantages and disadvantages of using that structure for your farm operation will provide assistance in making these decisions. Use this as a resource to help you be informed about Joint Ventures, Co-operatives and other Employment Agreements.

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### Governing Law

Use of this Manual and any disputes arising out of or in relation to this Manual shall be governed by, construed and enforced in accordance with the laws of Manitoba, Canada.

This publication was completed with the valuable contribution of Mona G. Brown, Harley Shepherd and Andrew Winkless.

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# Joint Ventures

## What is a joint venture?

A joint venture is a contractual relationship in which two or more parties agree to contribute resources to a common enterprise. The term joint venture does not have a specific legal meaning. Joint ventures are often similar to partnerships and may share many of the same characteristics. However, unlike partnerships and corporations, joint ventures are not governed by any act of Parliament or provincial legislature. As a separate form of business arrangement, joint ventures owe their existence to common law.

## Elements of a joint venture

Common law is the body of court decisions that establish legal rules and principles which are not the subject of any act of Parliament or legislature. In Canada there are a limited number of court decisions with respect to joint ventures, but the courts have set out the elements that are generally required for a joint venture to exist. Generally the elements of a joint venture are:

1. two or more persons
2. a contribution by each person of resources to a common enterprise
3. a joint property interest in the subject matter of the venture
4. a right of mutual control or management of the enterprise
5. expectation of profit
6. a right to participate in the profits
7. limitation of the objective to a single undertaking or for a specific time

### Two or more persons

A **person** includes a natural person, a sole proprietorship, a partnership, a trust, an unincorporated entity and a corporation. Any of these entities may enter into a joint venture.

### A contribution of resources to a common enterprise

For a joint venture to exist, each person involved must agree to provide something of value that will assist in furthering the venture itself. A person may make tangible contributions that are generally quantifiable or intangible contributions, the value of which are much harder to determine.

While the value of contributions of money and property can generally be established with little difficulty, assigning appropriate values to contributions of knowledge, skills, experience and time can pose considerable challenges. Whether or not the contributions of a person are difficult to value, a joint venture can exist provided the contributions add value to the enterprise.

Tangible contributions to a farming joint venture would be equipment, buildings, livestock or inventory. Intangible contributions would include such things as labour, specialized knowledge in marketing, farming techniques and personal expertise.

### **A joint property interest in the subject matter of the venture**

Each venturer must have some interest in the endeavor. In a farm, this is usually in the crop or appreciation and growth of the livestock herd, and in equipment owned by two or more of the co-venturers.

### **A right of mutual control or management of the enterprise**

Each party to a joint venture must have the ability to participate in making decisions. This ability must be part of the specific contractual obligations the parties have to one another with respect to the venture. The courts have held that allowing an individual with business acumen to make decisions for an enterprise does not necessarily satisfy the requirement that the individual have a right to control or management of the venture. The parties must intend to share control as part of their contractual obligations to each other.

### **Expectation of profit**

To establish a joint venture, the parties involved must have the intention to earn a profit from the enterprise. Once again, the intention of the parties at the time they enter into the joint venture contract is most important. The courts have made it clear that intention and motivation are not the same.

### **A right to participate in the profits**

Every person involved in a joint venture must have the right to share in any profits arising from the enterprise. The proportion of the profits each person will receive is generally agreed upon by all parties at the time the joint venture is formed. Any agreement reached with regard to sharing profits should be recorded in a written joint venture agreement. These entitlements to profits may change over time by amendment to the joint venture agreement.

For example, parent farmers form a joint venture with children. At the start, parents may own all equipment, but over time, the children may acquire more equipment and the ability to change the profit distribution is an advantage of a joint venture.

Profits in farming joint ventures should be shared in gross returns to co-venturers rather than be calculated at the joint venture level to distinguish it from a partnership (which calculates profits at the partnership level). Each co-venturer will calculate his or her individual profit by subtracting his or her expenses from his or her share of gross returns. This allows one co-venturer to receive a loss and another, a profit. This also gives co-venturers more opportunity to control their taxable income, and thus, their tax payable.

### **Limitation of the objective to a single undertaking or *ad hoc* enterprise – or limited time**

Court cases under common law and positions of Canada Revenue Agency support that a joint venture must be for a defined time or a limited and defined business undertaking. The duration can be long or short but not usually for an infinite period or for an unlimited enterprise.

### **Joint venture agreements**

A joint venture is a contractual agreement and a written contract is essential. This agreement should specify:

- a specifically defined enterprise – benefits to co-venturers may be tangible (ex: a certain crop or livestock inventory or money) or intangible (ex: an invention improving a piece of farm equipment, which might be the subject of a patent or patent pending)
- contributions of each co-venturer and default provisions
- specified interest in the production of the enterprise for each participant (ex: a percentage of every product or a 100 per cent interest in one product and zero interest in another product)
- limitation of liabilities to each co-venturer's share
- income treatment allocating gross revenue and expenses
- ability to compete with the enterprise
- financing as a joint venture uses money contributed by co-venturers, not borrowed by the enterprise
- restrictions on activities of the joint venture to a limited venture
- management and control/voting procedures
- term and termination

### **Advantages of a joint venture**

#### **Practical advantages**

Co-venturers are not liable for the actions of other co-venturers. If a farming couple wants to help a child or children to get into farming without risking their farm assets, a joint venture should be used. Partners are jointly and severally liable for the actions of all other partners. In addition, co-venturers are not agents of the venture, and normally, one co-venturer cannot bind another, thus giving each co-venturer a veto on any actions of the joint venture. Co-venturers each retain a distinct identity and can compete with the joint venture enterprise. Co-venturers do not have to put the best interests of the venture ahead of their other interests.

Example: Three potato farmers agree to construct a refrigerator storage facility for their mutual use. Each farmer can still bid against each other for the purchasing of other land, water rights or contract rights.

Example: Farmers in a joint venture agreement operate a custom spraying operation. Any of the co-venturers could also operate a separate custom spraying operation.

A joint venture offers flexibility and simplicity. Dissolution of a joint venture is simpler since most of the assets used in the joint venture are owned by the individual venturers. The setup is less costly than for other business structures.

## **Taxation advantages**

### ***Individual deductions for business expenses***

Unlike a partnership, a joint venture does not determine profits and losses separate from the parties to the joint venture. Parties to a joint venture receive a specified proportion of the gross income from the enterprise. They can deduct business expenses incurred in relation to the joint venture because they individually determine and control their own taxable income. As a result, a joint venture is not entitled to a separate GST number. GST is calculated at the co-venturer level.

In a partnership, the partners are entitled to share in the net income. It is the partnership itself, not the partners, that incurs expenses in relation to the business. Therefore, the partnership deducts those expenses before allocating income to the partners. The partners are not eligible to deduct expenses related to the partnership business. Partnerships have significant rules relating to dissolution and windup which co-venturers usually want to avoid.

### ***More than one small business deduction for corporations***

Corporations that have income of \$500,000 or less pay federal income tax on that income at the rate of 11 per cent as opposed to 28 per cent for income over \$500,000. Income over \$500,000 is credited to the general rate income pool (GRIP). This permits a corporation to declare eligible dividends, which have favorable tax treatment to offset the higher corporate tax rate on that income. Corporations that are in a partnership together share one small business deduction. A joint venture is a way for two or more farm corporations to combine resources and pursue common objectives while maintaining a separate small business deduction for each farm corporation.

It is common for each farming child to form a separate corporation in which they will build up equity in the future by buying land and buildings, equipment and inventory. It is also common for those farming children to need to use equipment and buildings owned by the farm corporation of their parents when they commence farming.

A joint venture of the parents' farm corporation and their child or children's farm corporation(s) to grow certain crops only allows all of the corporations to remain qualified for the small business deduction on each corporation's first \$500,000 of earnings.

NOTE: Manitoba's provincial tax limit is currently \$425,000 and set to increase to \$450,000 in 2016. Income between the Manitoba provincial tax limit and the federal small business limit of \$500,000 does not qualify for GRIP and does not permit the corporation to declare eligible dividends.

## Disadvantages of a joint venture

### Practical disadvantages

As the joint venture rarely owns land, the co-venturers, or if they are corporations, their principals, are usually asked to sign individual guarantees and individual guarantee mortgages.

As a joint venture and a partnership have a number of similar attributes and CRA considers each situation on a case by case basis, there is a risk that CRA will consider and deem the joint venture to be a partnership, which can have adverse tax consequences and is much harder to dissolve.

### Taxation disadvantages

The major tax disadvantage of a joint venture vs. a partnership is that the joint venture's interest is not considered capital property. Farmers do not have the ability to tax plan using their capital gains exemption on joint venture assets.

## When do you have a joint venture vs. a partnership?

The existence of a written joint venture agreement may provide evidence of the intention of the parties but may not be sufficient proof that a joint venture exists – even if clearly stated in the agreement and even if the agreement specifies that a partnership is not intended.

There are complex legal tests to determine whether or not a business arrangement is a partnership or a joint venture. It is important to seek the advice of an experienced lawyer if you are considering creating a joint venture. An experienced lawyer can assist you in developing a joint venture agreement that satisfies all of the requirements set out in *Joint venture agreements* on page 6 above.

## Family law considerations

As the co-venturers use their individual assets to contribute to the joint venture, a joint venture is not affected in the same manner as a partnership by marriage breakdown. Generally, the co-venturer's entitlement to gross profits and expenses will be factored into income for support purposes.

# Co-operatives

## What is a co-operative?

The International Co-operative Alliance defines a co-operative as follows:

A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.

As a business structure, a co-operative is an incorporated business that is owned and operated by its membership. The membership of a co-operative is generally composed of individuals, including corporations, who use and enjoy the benefits of the services provided by the co-operative. It is easy to tell when the business is a co-operative because the word "co-op" or "pool" must appear in the name.

Every co-operative must be organized and operated on a co-operative basis. In Manitoba, *The Cooperatives Act* sets out the criteria of what constitutes being organized, operated and carrying on business on a co-operative basis:

1. Membership in the co-operative is open, in a non-discriminatory manner, to people who can use the services of the co-operative and who are willing and able to accept the responsibilities of membership.
2. Each member has only one vote.
3. Interest on member and patronage loans is limited to a fixed maximum amount in the articles of the co-operative.
4. Dividends payable on membership shares are limited to the maximum percentage, fixed in its articles, of the par value of its membership shares. A co-operative may issue dividends on membership shares. These dividends should not be confused with patronage returns. Dividends are issued equally to all membership shares while patronage returns are based on the amount of business each member transacted with the co-operative in a fiscal period;
5. To the extent feasible, the members provide the capital required by the co-operative. From a practical perspective, members provide capital to the co-operative by leaving most of their patronage returns in the co-operative over many years. It is not uncommon for members of a co-operative to be paid a percentage of the actual patronage return;
6. Surplus funds arising from co-operative operations are used:
  - a. to develop business
  - b. to provide or improve common services to members
  - c. to provide for reserves or the payment of interest on member loans or dividends on membership shares and investment shares
  - d. for community welfare or propagation of co-operative enterprises
  - e. to provide member patronage returns based on the value of business transacted with the co-operative
7. It educates its members, officers, employees and the public on the principles and techniques of co-operative enterprise.

Co-operatives are generally not used as business structures for farming but they continue to be used by producers in purchasing goods and marketing commodities. The United Grain Growers and Manitoba Pool Elevators are perhaps the best example of marketing co-operatives that once dominated the grain trade in this province. By the end of the twentieth century the grain marketing co-operatives were unable to survive in the modern marketplace. Manitoba Pool Elevators merged with the Alberta Wheat Pool in 1998 to form Agricore Co-operative Limited. In 2001 Agricore merged with United Grain Growers and became a publicly traded company, Agricore United, ending almost a century of co-operative grain marketing in Manitoba.

Co-op grocery stores, hardware stores and credit unions are examples of co-operative businesses that still thrive throughout Manitoba.

## **Types of co-operatives**

Nearly any business can be organized on a co-operative basis, but there are three types of co-operatives that have traditionally been associated with agriculture:

1. supply co-operatives
2. marketing and processing co-operatives
3. new generation co-operatives

### **Supply co-operatives**

Supply co-operatives, as the name suggests, supply a variety of goods and services to farmers. Some of the most common goods provided through supply co-operatives include fuel and other petroleum products, feed, fertilizers and other crop inputs. Seed cleaning is an example of a service that is sometimes provided on a co-operative basis.

Some supply co-operatives are large retail operations that provide goods and services to a large membership and are not limited to any one type of business. The grocery, hardware and petrochemical businesses operated in Western Canada through Federated Co-operatives Limited are the best examples of large scale supply co-operatives. Other supply co-operatives may take the form of small groups of agricultural producers that have been organized to access discounts through larger scale purchasing.

Supply co-operatives will either provide goods and services at competitive retail prices or at cost, including a margin to cover operating expenses. Any profits will either be returned to the co-operative's members based on patronage, which is the value of business the member transacted with the co-operative, or reinvested in the cooperative business or local community.

Generally, supply co-operatives are allowed to provide goods and services to non-members to increase business and profitability. This is dependent upon the articles of each co-operative and the bylaws and resolutions of the co-operative's board. For example, most co-operatives operating as part of Federated Co-operatives Limited allow non-members to purchase goods and services. Every time a member makes a purchase, the member provides his or her membership number and the purchase is recorded for the purposes of determining what amount of patronage the member may be entitled to at the end of the co-operative's business year. Non-member purchases increase the profit of the co-operative, but the non-member does not have a membership account and does not receive a patronage return. Non-member purchases may therefore increase the overall return to members.

### **Marketing co-operatives**

Marketing co-operatives allow producers to pool their commodities for sale. Pooling commodities can allow producers to obtain professional marketing services that would otherwise be unaffordable to the producers as individuals. A marketing co-operative may pay market price for the commodity upon delivery, pay a pooled price based on average returns or simply act as a selling agent.

Market pooling was very popular at one time in Manitoba, with Manitoba Pool Elevators operating from 1925 until 1998. Market pooling provides farmers with the advantage of an average price for their commodities. No one ever receives the highest price for his or her commodities, but every member of the pool is also protected from receiving the lowest price.

The disadvantage of market pooling is loss of control by the producer over the timing and price of sales. Market pooling is no longer a popular means of marketing commodities.

### **New generation co-operative**

New generation co-operatives are a form of processing co-operative in which the members process and add value to their own raw commodities and are required to deliver specific amounts of the commodity they produce. The amount that any member is entitled (and required) to deliver to the co-operative is dependent upon the number of delivery shares he or she owns in the co-operative. The members will each hold only one membership share, but may hold several delivery shares.

New generation co-operatives issue a limited number of delivery shares based on the capacity of the processing facility. For example, assume a group of beef farmers decided to create a new generation co-operative beef processing facility. Their facility will be able to process 10,000 head of cattle each year. The co-operative will issue 10,000 delivery shares and each delivery share entitles a beef farmer to deliver one animal. When all delivery shares have been issued, they can be traded or sold to other producers provided the co-operative approves of the transaction.

The cost of delivery shares is generally determined by dividing the total amount of capital required to be raised from members of the co-operative by the processing capacity of the co-operative's proposed facilities. If the beef processing plant described in the example above cost \$20 million to establish and \$10 million is required from members, the cost of one delivery share in the cooperative would be \$1,000. The membership share may be minimal, as is the case in many other co-operative businesses

Depending on the articles and bylaws of the co-operative, the producer may receive a portion of the market value of his or her raw commodity at the time it is delivered. If the producer only receives a portion of the market value of the raw commodity at the time of delivery, similar to other marketing co-operatives, the producer may also receive a second payment with respect to his or her product after the commodity has been processed, sold and the co-operative has received payment for the product. The time it takes to process, sell, and receive payment is known as the operating cycle of the co-operative. In other cases the producer may have to wait for the end of the co-operative's business year and receive the remaining value in the form of a patronage return, if the board of the co-operative issues one. Whether or not a patronage return is issued will depend upon the profitability of the co-operative and any capital it requires.

## **Ownership of a co-operative**

The operations of a co-operative business are financed by those individuals who make use of the services provided. Capital investment in the co-operative business is one of the fundamental responsibilities of being a member of a co-operative. The capital investments of the members make a co-operative business member owned.

Public business corporations allow anyone that is interested to invest in the business, regardless of whether or not the investor will ever use the services provided by the business. Investors are primarily motivated by profit and the financial success of the business. Members of co-operatives typically seek the opportunity to collectively consider and address common problems, reduce the costs of doing business and improve and develop marketing opportunities. The businesses of the individual members are improved through the creation of a co-operative business that members both own and use.

In Manitoba, a co-operative may issue investment shares if the articles of the co-operative allow it to do so. The articles can also determine whether or not investment shares may be issued to individuals who are not members of the co-operative. If a co-operative allows investment shares to be issued to non-members, the co-operative business is only partially member owned.

## Control of a co-operative

Co-operatives are democratically controlled by the membership. Management of a co-operative is delegated to an elected board of directors. Every co-operative in Manitoba must have at least three directors, and the articles of the co-operative may set out an even larger minimum.

As discussed above, in Manitoba, a co-operative may issue investment shares. Shareholders of investment shares may elect no more than 20 per cent of the total number of directors of a co-operative. At least 80 per cent of directors must be elected by the members of the co-operative. All of the directors elected by the members must be members themselves.

Unlike a business corporation, each member may exercise only one vote, regardless of the amount of capital the member has contributed.

Shareholders of investment shares are not generally permitted to vote at a meeting of the members of a co-operative. The articles of a co-operative may allow shareholders to vote in limited situations. In such situations each shareholder may exercise one vote per investment share he or she owns.

## Patronage returns

When a co-operative earns a profit *The Cooperatives Act* mandates how the profit is to be used by the co-operative. Co-operatives most commonly reinvest profit in the co-operative business or distribute the profit to the members in the form of patronage returns. The patronage return to each member is determined by the amount of business the member has transacted with or through the co-operative.

## Advantages of co-operatives

### A co-operative is an incorporated entity

A co-operative is an incorporated entity and provides advantages similar to those of a corporation, including limited liability for its members and the ability to raise money by selling shares and taking loans. A co-operative also continues after the death of a member or members.

### **Equality of members**

The decision-making process is very clear and equal. Each member gets one vote, no matter how many shares the member owns.

### **Improved bargaining power**

Co-operatives are mechanisms that may allow farmers to pool resources to hire marketing professionals, to gather market information and share it with members, or act as a marketing agent. Farmers can make better informed decisions when selling commodities or have access to a professional salesperson that they may not have as individual producers.

### **Reduction of costs by achieving economies of scale**

Co-operatives can reduce the cost of marketing and processing by combining the smaller volumes of commodities of its individual members into larger volumes that may be more attractive when placed on the market.

Goods and services can also be purchased on a much larger scale by combining the smaller orders of the individual members. Costs of goods and services can often be reduced when large volumes are ordered by a single buyer.

### **Patronage**

When a co-operative business earns profits, the profits may be returned to the members as patronage returns. This may allow farmers to profit from the co-operative business while enjoying the benefits of the goods and services it provides. Patronage returns are issued at the discretion of the co-operative's board of directors. The amount of the patronage return actually paid to the members may be set out in the articles and bylaws or made at the discretion of the board. The co-operative may require the majority of patronage returns to be held by the co-operative as part of the concept of the co-operative's capital being supplied by the membership.

### **Risk reduction**

Marketing pools can help farmers avoid the unpredictability of fluctuating commodity prices by paying all members the same price averaged over the course of a set period of time.

## **Co-operatives do not pay tax on patronage returns**

The profits of a co-operative are not taxed at the organization level as long as they are allocated to the members as patronage returns. The co-operative will pay tax on profit that is retained for internal use. The patronage returns are taxed in the hands of the individual members annually, even if the total amount allocated to each member is not immediately paid to each member. It is common for a co-operative to retain a significant portion of the patronage allocation. By comparison, a corporation must pay tax on any profits before it distributes dividends to shareholders, but the shareholders each receive a dividend tax credit for a portion of the tax paid by the corporation before the dividend issued.

## **Disadvantages of co-operatives**

### **Substantial planning**

A co-operative business should not be formed unless the purpose and objectives of the co-operative are clear. Close attention should be paid to the needs of potential members and the amount of interest and enthusiasm that can be expected from potential members. Unrealistic expectations of the cost of doing business and inflated estimates of the amount of business the co-operative will transact need to be avoided. Competition, both real and potential, in addition to overall market conditions should be examined to determine whether or not the proposed co-operative business can obtain a sufficient level of business to sustain itself. In some cases this will be dependent upon the commitment of potential members. Relevant regulations from all levels of government should be identified and the impacts of those regulations on the co-operative business considered.

Given the large number of considerations that must be made, the organizers of a potential co-operative should seek professional advice about the feasibility and potential success of the business. Proper professional advice may make the planning stage very expensive and there may not be enough interest from potential members to fund the costs.

### **Leadership is voluntary**

The organizers of a co-operative business need to hire professionals with experience in establishing co-operative business ventures. Once established, the co-operative should seek out and hire experienced business people to manage the affairs of the co-operative business. Although a co-operative can rely on the advice of its employees and professional advisors, decisions must ultimately be made by the co-operative's leadership, the board of directors. In agricultural co-operatives, the leadership is likely composed of farmers who each have their own operations to attend to. If the leadership of a co-operative lacks the time, energy and enthusiasm to devote to the co-operative the chances of success are greatly reduced.

## **Membership must be committed**

Potential members may support the idea of a co-operative, but the membership may lack the commitment required to make a co-operative enterprise successful. Financing is largely obtained through the membership and the first year or more of business may not generate profits. If the membership does not have the means or the desire to invest in the venture, it is not likely to succeed.

## **Law imposes responsibilities on directors and officers**

Under the terms of *The Cooperatives Act* the directors of a co-operative direct the management and business affairs of the co-operative. The directors are empowered to appoint officers and delegate authority to manage the co-operative.

Directors and officers must comply with *The Cooperatives Act* and cannot be relieved of that duty. *The Cooperatives Act* requires directors and officers to:

1. Act honestly and in good faith with a view to the best interests of the co-operative.
2. Exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

The duties of directors and officers of a co-operative are the same as directors and officers of a corporation. The best interests of a co-operative (or a corporation) are not limited to the best interests of the members (shareholders). The directors and officers must look to maximize the value of the co-operative, which includes the long-term viability and productivity of the co-operative. There may be circumstances where the interests of members, employees, suppliers, creditors, consumers, governments and the environment all need to be considered by the directors.

The directors and officers also owe the co-operative a duty of loyalty, sometimes called a fiduciary duty. Directors and officers must avoid conflicts of interest with the co-operative and must avoid abusing their positions for personal gains. Directors and officers are required to disclose any interest they may have in a contract with the co-operative.

Confidential information obtained by virtue of being a director or officer must be kept confidential. A director or officer of a co-operative cannot seize a business opportunity that came to his or her attention by virtue of his or her position with the co-operative. This is the case even if the co-operative cannot seize the opportunity itself.

For more information about the responsibilities of directors and officers please see *Farm Corporations in Manitoba*.

## Tax on patronage return

As discussed above, when a co-operative makes a profit, it may return all or a portion of that profit to the members of the co-operative through patronage returns. Any profit allocated to members in a patronage return is taxable income to the member and not the co-operative. In many cases co-operatives do not pay the entire patronage return to members, only a specified percentage. The portion of the patronage return that is not paid to the member is added to that member's equity account and is may only be payable to the member in certain circumstances such as attaining a certain age or death. The patronage return that remains in the equity account allows the co-operative to continue to have access to the capital in the patronage returns for its operation.

This results in the members paying tax on patronage returns that they do not actually receive. For example, if Francis purchases \$100,000 of fuel for his farm from a supply co-operative over the course of a year and the co-operative board approves a patronage return of 5%, Francis will be allocated \$5,000.00. If the co-operative only allows 20% of that amount to be paid to Francis he will receive a cheque for \$1,000 from the co-operative, but will have to pay tax on \$5,000. Co-operatives in Canada are required to deduct and remit 15% income tax from any patronage return over \$100. Francis' co-operative will remit \$750 on his behalf, but the actual amount of tax Francis may be liable to pay will depend upon his income. Assuming Francis is not incorporated, he may have to pay tax at the much higher marginal rates on his patronage return, even though he only received a fraction of the amount allocated to him.

## Summary

Co-operatives were once a very popular business model for marketing grain in Manitoba. The co-operative elevators became unsustainable at the end of the twentieth century and have disappeared. Supply co-operatives remain strong, but most supply co-operatives in Western Canada operate in association through Federated Co-operatives Limited. Even financial co-operatives, such as credit unions, are increasing in size. The increasing size of farms and the increased volume of products that individual producers both consume and produce have given individual producers greater bargaining power to both buy and sell. The benefits of agricultural co-operatives have diminished as farms have become larger.

The use of agricultural co-operatives has greatly diminished. Successful co-operative enterprise requires a high level of planning, preparation, leadership, and commitment from members. If you are considering establishing a co-operative business, it is extremely important to consult with lawyers, accountants, and other professionals skilled in business development and management.

## Employment Agreements with family and other related parties

An employment arrangement may be combined with any other business arrangement. A farmer operating as either a sole proprietor or partner may employ a spouse or a child. A farmer that operates through a farm corporation can be employed by the corporation, in addition to a spouse or a child. It is important that the wages an employee receives are reasonable for the services being provided. Income earned by way of employment is taxed in the hands of the individual employee and therefore subject to the marginal rates of income tax. If you farm through a farm corporation, it is important to speak with your accountant and lawyer about whether or not an employment agreement is right for your situation.

### Written agreement

It is important to set out the rights and responsibilities of the employer and employee in a written employment agreement, regardless of whether or not the employer is the farmer, his or her farm partnership, or his or her farm corporation. The written agreement should include, at a minimum:

1. the duties the employee must carry out
2. the wage the employee will receive
3. how often the employee will be paid
4. the number of hours the employee will be expected to work each pay period
5. the time the employee will have to start work each day
6. which days will be holidays and what will be the employee's overtime pay

If a farmer employs a child, the employment agreement should take into consideration the child's age, any school requirements and other relevant circumstances that affect the child's ability to devote him or herself to the farm operation.

Employment is often the first step in any farming relationship between a parent and child. Often this will lead to the child becoming more involved in running the farm.

### Employment insurance

In Canada employers have a responsibility to pay a certain proportion of employment insurance premiums and make contributions to the Canada Pension Plan (CPP) on behalf of an employee. The employer is also responsible for deducting and remitting employment insurance premiums and CPP contributions that must be made by employees from the employees' wages. Employers are personally liable for these source deductions and should be cautious and ensure deductions properly calculated and remitted on time.

If you are considering an employment agreement with a related person, you may be eligible for an exemption from paying employment insurance. Farmers that operate as sole proprietors, or through a partnership, do not have to pay employment insurance on income earned through farming, although they may choose to do so to obtain employment insurance special benefits, which include:

1. maternity benefits
2. parental benefits
3. sickness benefits
4. compassionate care benefits
5. benefits for parents of critically ill children

Typically, employees and employers must pay employment insurance premiums. Section five of the *Employment Insurance Act* provides that employers and employees do not have to pay employment insurance for:

1. a person employed by a corporation, if the person controls more than 40 per cent of the voting shares of the corporation
2. an employee, if the employee and employer are not dealing with each other at arm's length

Section five contains other exceptions, but the two listed above are of the greatest relevance to farmers.

### **Employee of a corporation controls more than 40 per cent of the voting shares of the corporation**

This exemption is straightforward and best explained by an example: Anne and Percy farm through a corporation. Anne has 50 class A common shares and Percy has 50 class B common shares. Each common share is entitled to one vote. Anne is the person who runs the farm and is employed operating equipment, hauling grain and all other major farm work. Percy is employed to keep the records of the corporation and operate equipment. Anne and Percy each own 50 percent of the voting shares of the corporation. The corporation does not have to pay employment insurance premiums for Anne or Percy. Anne and Percy do not have to pay employment insurance premiums from the salaries they receive from the corporation.

### **Employee and employer not dealing with each other at arm's length**

The *Employment Insurance Act* provides that the question of whether persons are not dealing with each other at arm's length shall be determined in accordance with the *Income Tax Act*. Employees are related to their employer if they are related by:

- marriage or common-law partnership
- adoption
- blood, including parents, brothers, sisters or children.

Employees can also be considered related to an employer that is a corporation if the employee is related to a person who controls the corporation or is related to a person who is a member of a related group that controls the corporation. Employees are related to an employer corporation that is controlled by a family trust if they are beneficiaries of the trust.

In circumstances where the employer and employee do not deal with each other at arm's length, the employment is not considered to be subject to payment of employment insurance premiums. However, employment insurance premiums may be payable if Canada Revenue Agency determines that the employer and employee would have entered into a substantially similar employment agreement had they been dealing at arm's length.

If you have a farm corporation that employs someone you are related to, you should contact your lawyer about applying to Canada Revenue Agency for a ruling that the employment is not subject to payment of employment insurance premiums.

For example, Anne and Percy want to involve their daughter Joan in the farm. Anne and Percy's farm corporation enters into a written employment agreement with Joan in which Joan agrees to work on the farm for a fixed salary. Joan works very hard and has far more responsibilities than would be expected of an unrelated employee in Anne and Percy's operation. Anne, Percy and Joan talk with their lawyer and submit an application to Canada Revenue Agency for a ruling that no employment insurance premiums are payable for Joan's employment. They submit evidence that Joan works harder and has more responsibilities on Anne and Percy's farm than an unrelated employee would who earns the same salary and that Joan could have been hired as an employee without the extra responsibilities. Canada Revenue Agency issues a ruling that employment insurance premiums are not payable for Joan's employment, which is kept on record by Anne and Percy's corporation.

Please note that if Anne, Percy, and Joan had decided to pay employment insurance premiums and Joan continue to have extra responsibilities, there is a risk that Service Canada could find she is not eligible for benefits.

It is also important to note that CPP contributions from the employer and the employee must be remitted by the employer regardless of whether or not the parties are related.

## **Independent contractors**

There may be cases where a farmer and his or her employee believe it is beneficial to avoid the relationship of employment and instead create a contract for the provision of services. This allows the contractor to gain certain business deductions and relieves the person who has contracted his or her services from making source deductions. This can create a potentially dangerous situation. Whether or not someone is an independent contractor depends upon a number of factors. There are interrelated legal tests to determine whether or not an individual is an independent contractor or an employee:

- the control test;
- the integration test;
- the economic reality or entrepreneur test;

### **The control test**

The control test determines whether the individual is directed by someone who is in a position to control not only what is to be done but how it is to be done. Where such control is exercised over the individual it is an indication that the individual is an employee.

### **The integration test**

The integration test examines the level of economic dependence the individual has on the person or organization that contracts his or her services. If the individual works exclusively for one person or organization, it is an indication that the individual is an employee. If the individual contracts his or her service to third parties it is an indication he or she is an independent contractor.

The integration test also examines whether the tasks performed by the individual are an integral part of the business. If the services provided are critical, rather than accessory, to the operation of the business it is an indication the individual providing the service is an employee.

### **The economic reality or entrepreneur test**

This test examines several economic factors to determine the nature of the relationship. Some of these factors include:

- A) The existence of a written agreement, and the contents of same;
- B) Ownership of equipment;
- C) Who pays for gas, oil, maintenance and repairs of equipment;
- D) Who pays for the registration, licensing and insurance of the equipment;
- E) Does the individual hold him or herself out to be an independent contractor, in any other legal documents or income tax filings;
- F) Who controls or directs the hours of work;

- G) Who controls or directs the manner in which the work is done;
- H) Does the individual have a realistic opportunity for profit, or risk of loss;
- I) Is the individual working primarily for his or her own benefit, or for the benefit of someone else;
- J) Who decides when the work is to be performed; and
- K) Who decides when to take lunch, coffee, or rest breaks, and is prior approval for same required;

For example, an individual who owns a combine and custom harvests crops for numerous farmers is likely to be considered an independent contractor. If the same individual was hired to attend at a farm every day for a specific number of hours under the direct supervision of the farmer, using equipment owned by the farmer, the individual is likely to be considered an employee.

Whether or not an individual is an independent contractor or an employee depends upon the specific circumstances of the individual and those people for whom he or she works. Canada Revenue Agency may determine an individual is an employee regardless of any written agreement between the parties. If a farmer is deemed to be an employer and has not made source deductions, he or she may be person liable for both the employer and employee contributions to employment insurance premiums, CPP contributions, and other source deductions, plus interest and penalties for the entire period of the contract. The rules differentiating an independent contractor from an employee are complicated and there are specific legal responsibilities that flow from each relationship. You should consult your lawyer prior to entering into either arrangement.

## Income Splitting or Farm-Operating Agreements

Income-splitting or farm-operating agreements are written contracts, primarily between family members in the same farming operation, that determine how income from the farm will be divided, how decisions will be made, how much labour each will contribute and what assets each will contribute.

Canada Revenue Agency will likely classify these arrangements as either a joint venture or a partnership. Partnerships and joint ventures have separate and distinct taxation consequences. You should not enter into income splitting or farm operating agreements without the advice of your accountant and lawyer.

For more information about taxation of partnerships and joint ventures please see *Farm Partnerships in Manitoba* guide and the *Joint Ventures* section set out above.

## Capital Partnerships

The term capital partnership is being used to describe business arrangements in which a parent is able to transfer ownership of farm assets to his or her children without relinquishing control over the operation. Partnerships are well defined at law, and capital partnerships are not one of the three kinds of partnership recognized in Canadian law. For more information about partnerships please refer to *Farm Partnerships in Manitoba*.

While maintaining control of the operation, a farmer can transfer ownership of farm assets to his or her children in numerous ways. If you are interested in this kind of arrangement, please see your lawyer or accountant about what is best for your specific situation.

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## Contact us

- For more information, contact a Farm Management Specialist
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