Ontario

MINISTRY OF AGRICULTURE, FOOD AND RURAL AFFAIRS

# Farm Business Joint Ventures

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## Introduction

The joint venture is an ideal business structure when an arrangement that is flexible and less formal than either a partnership or corporation is needed. The joint venture can be used to test a business relationship or allow a child to gain management experience and ownership in business assets. The purpose of this Factsheet is to help farm business owners understand what a joint venture is and when it may be a suitable business structure for them to utilize. This Factsheet is part of a series covering farm business structures.

Other OMAFRA Factsheets on farm business structures are:

- Farm Corporations, Order No. 16-033
- Farm Partnerships, Order No. 11-019

## Section 1 - The Basics of a Joint Venture

### What is a Joint Venture?

A joint venture, while not defined in the Income Tax Act*,* generally refers to a business structure that closely resembles a partnership but lacks one or more of the essential elements of a partnership. In effect, a joint venture is defined by the absence of key partnership elements, as outlined below. Because of this, it is important to understand the definition of a partnership so that business owners do not inadvertently enter into a partnership arrangement when a joint venture structure is intended. The result of making such a mistake could mean the assumption of unwanted liability for other parties' debts or undesired tax consequences. The standard definition of a partnership is "a business relationship where two or more persons carry on a business with a view to make a profit."

A partnership has the following characteristics:

- an agreement to share the profits and losses of a business exists
- the ability of each partner to contractually bind the other partners
- joint ownership of property (although it is common to hold some property outside of the partnership)
- the use of the words "partner" and "partnership' in any written documentation (i.e., how the relationship is perceived by third parties);
- the use of a partnership name, joint bank account, joint accounting, single financing, etc.

- formal registration as a partnership.

For more information on partnerships, see OMAFRA Factsheet Farm Partnerships, Order No. 11-019.

In contrast to the above list joint ventures differ from partnerships in the following ways:

- A joint venture has a specific term to its existence (e.g. 1 yr, 5 yr or when something specified is accomplished). A partnership often has an undefined term.
- The objective of a joint venture usually is to carry out a single project or a limited number of projects.
- In a partnership, the partners share profits. In a joint venture, the venturers share a percentage of the revenue and expenses based on their percentage of contribution to the joint venture. (see the section below "Does a Joint Venture Share Profits?")
- The joint venture does not borrow money, the individual venturers do.
- The parties in a joint venture retain individual ownership of assets (land, buildings, machinery, livestock) but contribute the use of the assets to the joint venture.
- Participants will prepare their own business income statement to reflect their operation of the joint project. Each venturer is free to report and claim reserves and other discretionary deductions or elections individually for tax purposes.
- A joint venture does not have a fiscal period per se. Administratively, CCRA will normally allow a joint venture to establish its own fiscal period, which may differ from the fiscal period of each venturer, provided that all participants agree to it.
- A sale of an interest in the joint venture is simply a sale of the seller's undivided interest in the assets in the joint venture. Thus a sale may result in recapture (if the asset is depreciable property), ordinary income, or capital gains depending on the nature of the asset.
- Generally, a joint venture ends upon the completion of a project or upon the sale of all assets used by the joint venture.

## Does a Joint Venture Share Profits?

The distinction between sharing net profits verses gross revenue is one of the defining features of the joint venture and one that is sometimes unclear.

Partners in a partnership have the right to participate in the profits and share equally the losses of a partnership in proportion to their partnership interests. In the absence of an agreement to the contrary, partners are deemed to have equal interests in the enterprise. In contrast, while joint venturers are interested in ensuring that the venture operates profitably, it is a profit for the individual venturers as opposed to the venture itself that is important. For example, a joint venture in a beef feedlot operation where cattle and feed are jointly contributed to the project may yield profits for one venturer and not the other depending on when each venturer elects to sell their cattle. In addition, the expenses and overhead of each venturers other business enterprises may impact on the overall profitability of the joint venture for any particular venturer.

In a joint venture profits and expenses are "allocated" to the venturers as opposed to any general assumption of equal participation. In addition, the individual parties to a joint venture participate only in the profits and losses of the activities undertaken by the venture; they do not participate in the profits, losses or risks of the other parties or their other business activities.

## Why Form a Joint Venture?

Joint ventures, sometimes called "working or operating arrangements", are commonly used in parent and child business arrangements. They allow the child to gain both management experience and ownership in a business. They can also be dissolved more easily than either a partnership or corporation. This makes them an ideal structure in which to test a business relationship.

Unrelated individuals appreciate that with a joint venture they can maintain control over a specific business undertaking while remaining separate business entities.

Joint ventures can involve:

- the complete farming operation where income from all assets are pooled,
- only part of a farming operation such as a livestock or crop enterprise or
- just a specific asset, such as a combine.

Some landowners enter into joint ventures rather than lease their land in order to maintain farming income and thereby preserve some specific income tax deferrals such as rollovers to children.

Listed below are some of the other advantages and disadvantages of a joint venture.

**Advantages and Disadvantages of Joint Ventures**

**Advantages**

- Assets are owned individually and may be rolled over on a tax-deferred basis on a transfer from a parent to a child.
- Capital assets are shared, which may allow fixed costs to be spread over a larger base, lowering costs of production.
- Labour and management are shared, which permits more specialization and provides individuals with more time off than if the individuals operated sole proprietorship farms.
- Dissolution of a joint venture is simple.
- Share ratios may be changed easily between years.
- Cost to establish is low.
- Allows younger generation to develop management experience.

**Disadvantages**

- As with all types of farm business arrangements, there is the potential for disagreements - good communication techniques must be practiced.
- A joint venture could potentially be interpreted as a partnership with the associated negative income tax and liability implications.
- Each party does not have the freedom of independence in action and decision making as in a sole proprietorship.

## How is a Joint Venture Taxed?

A joint venture does not file income tax. The venturers report the income from the joint venture on their personal tax filings. Because the joint venture typically does not own assets the Capital Cost Allowance is claimed by the individual venturer who owns the equipment.

## Section 2 - Forming the Joint Venture

## Ownership of Inventory

Typically the joint venture does not own any assets. However as agricultural joint ventures often involve producing a commodity, there is an issue of how to handle inventory - in particular how to treat opening inventory or changes to the percentage used to calculate the splitting of income and expenses. Some options for handling inventory are:

- Inventory on hand at the beginning of the joint venture belongs to the contributor. This inventory could be valued at its fair market value and that value could be considered a loan to the joint venture.
- Inventory on hand at the end of a venture would be divided in accordance with the percentage shares of the parties. If sold it could be split on that basis or, if held, that value could be considered a loan to the joint venture.
- Inventory on hand when a share ratio is changed would be shared on the previous share basis.

## Joint Venture Agreements

To establish that a business relationship is a joint venture and not a partnership, draw up a joint venture agreement outlining the parties' intentions, rights, and obligations.

The joint venture agreement often allows the venturers to:

- participate in decisions on common issues relating to the joint operation
- assign their interest without the consent of co-venturers
- freely compete with co-venturers
- use for their benefit, any knowledge or information gained from the joint venture

The joint venture agreement also identifies:

- the objective of the joint venture
- the contribution, role and involvement of each co-venturer
- how long the joint venture will exist
- how the project will be managed
- allocation of revenues and expenses from the project
- the events that can trigger the withdrawal of a venturer or the termination of the project.

## Spousal Joint Ventures

While spousal partnerships are much more common as an alternative to paying a wage to a spouse, a spousal joint venture could also be used in the same fashion. This would permit each spouse to receive a share of the farm's revenue and expenses.

As long as each spouse contributes capital and/or labour and management, then a joint venture can be justified. A joint venture may be more advantageous than paying a wage to a spouse if the spouse's capital contribution is significant. The division of income between husband and wife should be reasonable given their respective contribution of capital and labour to the joint venture.

Capital contributed must in fact belong to the spouse making the contribution. Capital given by one spouse to the other is really the capital of the giver. Such an arrangement by itself would not guarantee that future capital gains could be split.

## Section 3 - Operating the Joint Venture

## Decision Making

Joint venturers are free to conduct other business apart from the joint venture activities, even if it is in direct competition with their joint venture. In addition no venturer has the authority to act on the other venturers behalf with regard to assuming any liabilities or responsibilities. In this respect the joint venture differs from the partnership structure. In most cases, the decision-making authority is shared by the venturers on an equal basis and decisions are mutually agreed to. In the case of a parent-child joint venture where contributions to the venture are more likely to be unequal, consider adding a clause outlining how a decision would be reached where there is no mutual agreement. For instance the agreement might state what percentage of the vote certain venturers would have.

## Allocation of Joint Venture Income and Profits

Every joint venture must determine how the income of the venture will be divided among the co-venturers. Table 1, Allocation of Joint Venture Income and Expenses, shows an example of a joint venture between a father and a son. In this example the father contributes $450,000 of assets and the son $50,000. They both agree that they want a 4% return on their investment of land and a 6% return on all other investments. The father will receive $15,000 for his return for labour and the son will receive $25,000. Note that for tax purposes, the salary paid to a venturer is not an expense. It is just part of the income-splitting formula.

In our example, the father receives a 52.5% share of income and the son 47.5%. The expenses are then allocated on the same basis. A new calculation should take place each year based on the investment in the joint venture by each party. For tax purposes maintain good records as to the amount taken out of the joint venture and the amount of income share left inside the joint venture.

If two joint venturers wanted a 50:50 income and expense sharing arrangement, but their land holdings are not equal, one solution would be for the joint venture to rent each parties land. This would be fair as long as other contributions, such as machinery, labour and management, were of equal value.

### The Contribution Approach

The contribution approach is used in the Table 1 example to arrive at a profit sharing percentage for each of the venturers. Since the parties may contribute labour, management and capital to the joint venture, it is reasonable to divide the income or expenses based on the relative contributions of each party. The underlying principal is that returns are to be shared in the same proportion as the costs and capital are contributed.

### Valuing Contributions

In calculating the contributions of each party, it is important to use realistic estimates of value. Use market values in valuing assets. Value labour and management at what each party could earn elsewhere, or what it would cost to hire the services each party provides to the farm. Interest on investment should be approximately the same as long-term interest rates. However, with land a lower interest rate may be used since land normally has long-term capital appreciation in addition to the annual rental return it can generate. The joint venture contribution would reflect only the annual return, and therefore a lower investment rate can be used.

Review the share ratio whenever there is a change in the relative contributions of capital and labour or management by any of the parties.

## Day-to-Day Operating Procedures

The day to day handling of income and expenses for a joint venture is made simpler by establishing a joint bank account for the joint venture and separate individual bank accounts for the individuals. There are 2 ways that income and expenses can be handled.

1. All income and expenses are deposited and paid from the joint venture account. Venturers would take drawings from this account in the proposed split.
2. Income from the joint venture is paid directly to the venturers and deposited in their personal accounts. Funds are advanced to the joint venture account in the agreed to percentage to cover the payment of joint venture expenses.

Even though the parties may refer to the drawings as a salary or wage, it must always be considered as a draw. Individuals pay for personal expenses, debt servicing and capital purchases from their separate bank accounts.

### Accounting

For accounting purposes, a separate accounting system should handle all transactions through the joint account. In addition, each individual should have an accounting system for his personal and business related transactions handled through the individual bank accounts. This creates at least three accounting systems for a two-person joint venture. However, there will only be a few transactions in each individual's accounting system. The joint venture's accounting system will have the most transactions.

The accounting system should account for all flows of money between the individuals and the joint venture. Further, the flows of money should differentiate between payments on loans, capital, drawings, etc.

At each year end, any annual surplus in the joint venture is paid out to individual parties. The following year can then start fresh. If the joint venture requires operating capital, the individual parties could "loan" funds to the joint venture.

## Section 4 - Dissolving the Joint Venture

## Dissolution

On dissolution of a joint venture each party would be entitled to their individually owned assets, plus their share of farm inventory, less operating costs. Since in most cases the individual parties own the assets contributed to the joint venture there is no taxable disposition of assets when the joint venture winds down.

The joint venture agreement usually sets out the conditions upon which the joint venture is terminated. These might include one of the venturers disposing of their assets used by the joint venture, or the death of one of the venturers. It could also be the arrival of date upon which the parties have decided to terminate the joint venture or when one of the parties gives notification.

**Table 1.** Allocation of Joint Venture Income and Expenses

| **Details** | **Father** | **Son** | **Joint Venture** |
|---|---|---|---|
| **Fair Market Value of Assets Contributed to the Joint Venture** | | | |
| **Land** | 300,000 | 50,000 | 350,000 |
| **Buildings and Improvements** | 75,000 | - | 75,000 |
| **Machinery and Equipment** | 75,000 | 100,000 | 175,000 |
| **Other Assets** | 0 | 0 | 0 |
| **Total Investment** | 450,000 | 150,000 | 600,000 |
| **Percentage Investment (%)** | 75.0% | 25.0% | |
| **Labour and Investment Calculations** | | | |
| **Salary for Labour and Management** | 15,000 | 25,000 | 40,000 |
| **Return Desired on Land — 4%** | 12,000 | 2,000 | 14,000 |
| **Return Desired on all other assets — 6%** | 9,000 | 6,000 | 15,000 |
| **Total Labour and Investment Allocated** | **21,000** | **8,000** | **29,000** |
| **Joint Venture Income and Expense Allocations** | | | |
| **Revenue from Joint Venture** | | | 260,000 |
| **Operating Expenses of Joint Venture** | | | 190,000 |
| **Net Income of Joint venture** | | | 70,000 |
| **Amount allocated as Salary** | 15,000 | 25,000 | 40,000 |
| **Balance after Salary allocations** | | | 30,000 |
| **Amount allocated as Interest on Investment** | 21,000 | 8,000 | 29,000 |
| **Balance after Interest allocations** | | | 1,000 |
| **Amount allocated Based on Percentage of Initial Investment** | 750 | 250 | 1,000 |
| **Balance after all allocations** | | | 0 |

| | | | |
|---|---|---|---|
| **Share of Joint Venture Income** | 36,750 | 33,250 | |
| **Percentage Share** | 52.5% | 47.5% | |
| **Allocation of Revenue** | 136,500 | 123,500 | |
| **Allocation of Expenses** | 99,750 | 90,250 | |
| **Allocation of Gross Profits** | 36,750 | 33,250 | |

## Summary

A joint venture is just one of a number of business arrangements which a farm business can use. It is suitable as an intermediate structure to test a business relationship or where the parties do not want to enter into a more permanent and restrictive business arrangement. Farm business owners should consult with their advisors to determine which arrangement is most suitable for their business.

This publication is intended as general information and not as specific advice concerning individual situations. Although it outlines some of the legal and tax considerations of joint ventures it should not be considered as either an interpretation or complete coverage of the Income Tax Act or the various law affecting joint ventures. The Government of Ontario assumes no responsibility towards persons using it as such.

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