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Splitting up a farm corporation

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The time may come for operators of a farm corporation to split up as a corporate entity. Family members who have farmed together may desire independence, or they may want to segregate aspects of their operations into multiple separate corporations. Siblings who have farmed together for years may decide to go their separate ways as either part of succession planning for their children or simply a desire to farm on a stand-alone basis. A portion of the operations may also be spun out of the corporation in order to maintain the corporation's status as a "family farm corporation." While operations such as a grain elevator or a custom spraying machine may be related to farming, if these assets are not used principally in a farming business they could put the farm offside of the definition of a share of the capital stock of a family farm corporation.

How is a split achieved?

Farmers contemplating a split might wonder whether it can be done without triggering taxes. The answer depends on a number of factors and the applicability of some specific provisions of the *Income Tax Act* (ITA).

Pursuant to subsection 85(1), assets may be transferred from the existing corporation to a new corporation without triggering tax. However, if the transfer of assets is the only step taken, the existing farm corporation will still own shares in and/or have promissory notes owing from the new corporation. The strategy would not achieve the objective of severing the ties between the operations, with siblings' operations remaining intertwined, or the farm shares still offending the definition of a share of the capital stock of a family farm corporation.

The intercompany shareholdings must be redeemed in order to sever the ties, resulting in deemed dividends between the corporations. However, unless certain requirements are met, these intercompany dividends could be re-characterized as capital gains, resulting in taxes owing on the transaction. Two specific provisions must apply in order for the split to be carried out tax free. These provisions are commonly referred to as "the butterfly rules."

With no unrelated parties

The simpler test requires that the transactions not involve any unrelated parties. However, the test is not as simple as it might appear. While siblings are considered to be related in most provisions of the ITA, they are specifically deemed not to be related for the purposes of section 55, where the butterfly rules are found. Thus, in the relatively common situation of a corporation controlled by two siblings, section 55 prevents the split from occurring on a tax-free basis. If the corporation is still controlled by the parents and the two siblings are minority voting shareholders, the split may be structured using this provision. The parents must maintain control of both corporations subsequent to the split and may not transfer control to the children as part of the split.

With unrelated parties

If a company is owned by two siblings (unrelated parties for these provisions of the ITA) who wish to split or spin out a division, the transaction must meet the criteria of paragraph 55(3)(b) in order to defer taxes.

For the purposes of this provision, there are three types of property: cash and near cash, business assets, and investment property. In order to meet the butterfly requirements, each corporation must hold a pro-rata share of these three types of assets (i.e. if a

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corporation has 25 per cent of the value of business assets after the split, it must also have 25 per cent of the value of each of the cash assets and the investment assets). Additional rules allocate liabilities between the three asset types. Though the process might appear simple, it is often filled with difficulties. There are many rules specifying what may and may not be done both before and after the split. The corporation may not simply buy additional assets of a certain type in order to achieve the appropriate proportion of asset types; a rule denies the tax-free treatment if assets are acquired in contemplation of a butterfly.

For example, consider a farm with both a dairy operation and significant cash crop activities owned by two brothers who each hold 50 per cent of the outstanding shares. All farm assets are owned by the corporation. One brother intends to carry on dairy farming while the other brother will focus on cash cropping.

In this case, a split could be structured such that farm land, equipment and machinery would be transferred to a new corporation. These assets transferred must be equal to 50 per cent of the total business assets of the existing corporation. Cash and cash equivalents would also be transferred at the same 50 per cent ratio, as well as investment assets (rental houses, marketable securities, etc.), if any. The existing corporation would retain dairy quota, barns, livestock, milking equipment and some of the land base, as well as the other 50 per cent of the cash and investment assets.

Achieving an appropriate split of assets and liabilities may not be possible in all cases. A split that meets the pro-rata distribution requirement might not meet the operational needs of the farm in terms of cash flow, required land base for nutrient management planning, etc. Where significant debt is involved, owners must also consider whether there will be sufficient security and whether banking covenants will be met by the newly separated farms.

Due to the complexity of the butterfly provisions in the ITA, the professional fees to carry out a split of a farm corporation can be significant. The process of planning for the split, obtaining fair market values, negotiations between shareholders and external stakeholders such as lenders, determining an appropriate split of assets and liabilities, and completing tax elections and legal agreements can take considerable time. All stakeholders should thus be fully committed to the plan and the necessary time and costs.

If you think a split might be necessary for your farm, contact your Collins Barrow advisor to discuss the applicability and impact of the butterfly rules.

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