Canadian Federation of Agriculture Submission to the Standing Senate Committee on National Finance

Study of the proposed changes to the Income Tax Act respecting the taxation of private corporations

November 2017

Scott Ross
Director of Business Risk Management and Farm Policy
21 Florence street
Ottawa, Ontario K2P0W6
scott@canadian-farmers.ca
cfa-fca.ca

The Canadian Federation of Agriculture:

This submission represents the official position of the Canadian Federation of Agriculture (CFA), Canada's largest farmers' organization, through its members representing nearly 200,000 Canadian farmers and farm families from coast to coast. CFA was formed in 1935 to answer the need for a unified voice to speak on behalf of Canadian farmers. It continues today as a farmer-funded, national umbrella organization representing provincial general farm organizations and national commodity groups. CFA's mission is to promote the interests of Canadian agriculture and agri-food producers, including farm families, through leadership at the national level and to ensure the continued development of a viable and vibrant agriculture and agri-food industry in Canada.

CFA's Perspective:

Since the Department of Finance Canada released the consultation document, Tax Planning Using Private Corporations, on July 18th, 2017, with a subsequent 75-day consultation period taking place during harvest, CFA has heard unprecedented concern from farmers across Canada. CFA has been pleased to hear recent announcements from Minister Morneau that the proposals relating to the lifetime capital gains exemption (LCGE) and conversion of income into capital gains would not be moving forward. These proposals posed considerable challenges to succession planning and intergenerational farm transfers more broadly, as noted in CFA's October 2nd submission to Finance Canada.

The remaining proposals, simplifying the proposed reasonableness test, clearly accounting for past contributions, and imposing a $50,000 annual threshold on passive investment income, represent steps in the right direction; however, concerns still remain with regard to the details of these proposals. Once available, further analysis of these details is required to assess the full scope of potential consequences.

Minister Morneau also announced that legitimate family farming practices are not the intended target of these proposed changes. The CFA is committed to working with the Department of Finance to ensure this end result. The CFA looks forward to working with Finance Canada as they continue their outreach to farmers and other business owners over the next year to assist in developing proposals that would better accommodate intergenerational transfers of businesses while protecting the fairness of the tax system. Minister Morneau clearly stated that the proposals regarding the conversion of income to capital gains would not move forward, yet Section 84.1 of the *Income Tax Act* (ITA) remains a long-standing concern for the agriculture sector, as noted in the CFA's pre-budget submissions for a number of years.

The comments provided within this submission reflect the initial, key concerns noted by the CFA through a preliminary analysis of the proposed amendments, in the absence of more specific details. While the CFA strongly believes that further analysis and dialogue is required to avoid unintended consequences, we hope these notes will provide valuable guidance in ensuring any future legislation is appropriately targeted.

It is also noteworthy that this consultation was first announced in the 2017 Federal Budget, which laid out a clear vision for innovation and growth in Canada's agri-food sector with ambitious targets for growth in agri-food exports[i]. Continued dialogue to further refine further legislative proposals on income sprinkling and passive investment income is required to ensure Canada's agriculture industry can meet these export targets, grow the sector, and contribute to inclusive economic growth in regions across Canada. The CFA believes that continued, extensive consultation and engagement with the farm sector remains critical to ensure that there are no unintended consequences.

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Income Sprinkling: A simplified reasonableness test

The CFA's October 2nd submission to Finance Canada noted considerable concern with the reasonableness test for a number of reasons. Broadly speaking, these concerns fall within two specific areas:

1) The compliance burden imposed on small businesses and the Canada Revenue Agency by a reasonableness test, given the diversity of contributions made by family members, particularly in a family farm context; and
2) The subjectivity inherent in determining whether a dividend paid to a non-arm's length individual would be deemed reasonable, especially when compared against what an arm's length individual would receive for similar contributions.

Meaningful Contributions

On both fronts, the CFA was pleased to see the Government of Canada announce plans to simplify the proposals addressing income sprinkling, particularly the note that "businesses with family members who meaningfully contribute to the business will not be impacted"[ii]. The CFA awaits further details on the implementation of a simplified test, but would note ongoing concerns with compliance and subjectivity.

To address the concerns noted in points 1) and 2), the CFA strongly recommends that Tax on Split Income (TOSI) only be applied in situations where no contribution of any kind has been made to the business. The assessment as to whether a contribution has been made must be objective, clearly defined and simple to understand. Any test imposed to determine whether a contribution was either 'reasonable' or 'meaningful' will introduce subjectivity, which introduces uncertainty and a considerable compliance burden, effectively undermining farm businesses' financial planning. If an objective contribution test is not possible, the CFA strongly recommends that farm income be exempt from TOSI treatment.

In addition to these considerations, the CFA believes that the farm family context must be taken into close consideration under any contribution test. Farm family members contribute to the farm business in a myriad of direct and indirect ways that are difficult, if not impossible, to capture in a clearly documented fashion. For example, CFA strongly recommends that child-rearing activities undertaken by a spouse, allowing other family members to commit additional, uninterrupted time to the business, represents important contributions to the business that must be accounted for.

Holding Companies & Operating Entities

Holding companies and operating entities are often critical components of a farm business. Clause (b)(II)(B) of the definition of 'split income' makes a distinction between the operating entity and the source business, while subparagraph (b)(iii) of the definition of 'split income' provides that the contributions of labour, capital and risk have to be provided to the source business and not to the operating entity. As a result of these clauses, a specified individual's contributions to the operating entity or to a holding company would not qualify as meaningful contributions to the source business. For most farm businesses holding companies, operating entities, and source businesses reflect inter-related components of a single business.

Each of these entities can play an important part in a farm business operation. For example, holding companies often play important roles in the long-term plans required to facilitate succession for many multi-generational farming

operations. For this reason, CFA recommends that contributions made to holding companies and operating entities should be taken into account under any future reasonableness test or related analyses of contributions.

Treatment of Capital Gains & The Farm Rollover Provisions

Throughout the consultation process, and in Minister Morneau's recent announcements, farm stakeholders have regularly been informed that the Government of Canada "recognize[s] the importance of maintaining family farms" and that they will "work with Canadians to ensure [they] don't affect the transfer of a family business to the next generation."[iii] To ensure intergenerational farm transfers are unaffected by future legislation targeting income sprinkling, the CFA believes it is critical to consider the potential implications of TOSI's application to capital gains that exceed the LCGE. CFA remains concerned that TOSI may affect the sale of shares of a company by family members, with capital gains potentially reclassified as dividends if deemed 'unreasonable'.

Capital gains associated with the transfer of a farm from one generation to the next may very well exceed the LCGE. The potential imposition of TOSI via a reasonableness or meaningful contribution test will create undue, costly uncertainty. This could create additional transaction costs, in terms of potential fees for advisory services, while also potentially reducing liquidity available to facilitate the transfer due to inflated tax liabilities. Therefore, CFA recommends that the treatment of capital gains be closely considered in advance of any impending income sprinkling provisions, specifically to ensure they will not impede intergenerational farm transfers.

This is particularly true in instances where the farm rollover provisions within the ITA have been utilized and, as a result, children of farming families are able to receive certain farm property through a tax-deferred rollover[iv] or, upon death, below fair market value (FMV)[v]. To ensure TOSI and any contribution test do not undermine farm families' capacity to transfer farms to the next generation, the CFA strongly recommends that the farm rollover provisions be accommodated to protect their continued utility. Specifically, CFA recommends that the Adjusted Cost Base (ACB) of any farm property transferred from parent to child through existing farm rollover provisions must be considered a contribution on the part of the farm child. This contribution should be recognized to ensure that any contribution test or application of TOSI does not create unintended consequences for intergenerational farm transfers.

Implementation of Income Sprinkling Provisions

Finally, CFA notes the need for caution in implementing any new tax regime on income sprinkling. The implementation date for a revised tax income sprinkling regime has been set for January 1st, 2018. Recognizing that final legislation will not be available until extremely late in 2017, the CFA believes it is essential that implementation be delayed to no earlier than January 1st, 2019, to allow farms and small businesses across Canada with sufficient time to assess, internalize, and plan accordingly within the new tax regime. With many critical details still to come to light, this additional time is critical.

Passive Investment Income: The $50,000 threshold

Although details regarding future passive investment income provisions remain unclear, the CFA believes Minister Morneau's announcement regarding imposition of a $50,000 threshold and grandfathering of existing passive investments are important steps in the right direction. Further details and subsequent analysis is required before a final opinion can be drawn on the threshold identified. In the absence of such details, the CFA believes it is important to note areas of potential concern with respect to any passive investment income tax regime.

Ensuring Investments for Legitimate Business Use are not Affected

First and foremost, it is critical that any future proposals do not create inherent disincentives to the retention of passive investments within a corporate structure. Passive investments are often maintained for future expansion, potential economic downturns, or to manage personal circumstances that would otherwise directly affect their business, such as for parental leave, sick days, or retirement plans. If the Government of Canada intends to impose additional taxes upon passive investment income, CFA recommends that any such taxes only be levied when such income is dispensed through dividends to shareholders for personal use, and not on an annual basis while they remain retained within the business.

The compliance regime associated with differentiating between dividends derived from active vs. passive investment income must also be streamlined and administratively efficient, to ensure retention of passive investments are not treated punitively. These measures would help ensure that any income held for future growth and/or further investment in the business remains unaffected.

One area of particular concern to farm businesses is the treatment of farmland rental income. Active farm business owners and those in the process of transferring their farm to the next generation rely extensively on the income derived from farmland rental for many reasons; this income is essential to effective risk management and succession planning. CFA strongly recommends that farmland rental income received by an active farming business, or from farmland held by the current owner within a previously active farming business, be treated as exempt from any additional tax increases imposed on passive investment income. This income must also not count against the threshold that exempts the first $50,000 of passive investment income from forthcoming tax increases on investment income.

Unexpected events also pose a considerable concern in this regard. Death, illness, or other unanticipated events can quickly change long-term plans for a farm business, in many instances requiring the dissolution of a corporation or the immediate, unexpected need to purify farm assets so that farm rollover provisions can be utilized. For example, passive investments may be held within a farm corporation to provide for expansion, awaiting availability of appropriate farmland. If a death occurs and such an opportunity has not presented itself, capital gains relating to this legitimate growth fund could very well be deemed passive investment income and as a result, taxed at punitive rates.

To ensure legitimate investments are not unduly taxed, the CFA recommends that any capital gains from passive investments be taxed as they would under the current tax regime where justification can be provided to demonstrate an unexpected event has derailed legitimate business plans. Without the ability to justify the appropriate treatment of legitimate business investments, unexpected events would regularly see farms and other small businesses face significant tax increases on any investment income that exceeded the $50,000 threshold. Also, if assets used in the farming business are to be sold, the taxable capital gain from the sale of these assets could exceed $ 50,000. This taxable

capital gain should be subject to the current tax rate for property income and not any future rate proposed for passive investment income.

A Cumulative Threshold and Indexing to Inflation

Recognizing that the $50,000 income threshold for passive investment income is based on the income generated by passive investments, rather than on the total amount of passive investment from which that income is derived, the CFA recommends that any such threshold should be treated as cumulative over time. Volatility in investment markets and potential returns means that the $1 million in assets touted in announcements to date could easily exceed any annual threshold in a given year, while subsequent years could see significantly lower returns.

To ensure the intent of the provision is maintained, without creating punitive tax situations due to inherent volatility in the marketplace, the $50,000 threshold should be treated in a similar manner to RRSP and TFSA contributions. Thus, any annual difference, where passive investment income falls below the $50,000 threshold, should be carried over into future years to provide adequate buffer against market volatility that is beyond the control of any individual business owner. Furthermore, the CFA recommends that the threshold be indexed to inflation to ensure the utility of this threshold is maintained over time.

The Need for Further Consultation

Given the paucity of information on potential passive investment income provisions, the CFA also strongly recommends that sufficient space and time be made available for additional consultation. Further consultation on any future provisions is required to ensure unintended consequences are recognized and addressed before any such proposal comes into effect.

Outside Investment and Growth in the Agriculture Sector

Canada's agri-food industry has been identified as a sector with potential for significant growth and contribution to inclusive growth across Canada. Budget 2017 acknowledged this potential by highlighting agri-food as a target sector in its Innovation and Skills Plan and setting an ambitious growth target that would see agri-food exports increase from $56 billion to $75 billion by 2025. While farmers continue to invest heavily in their operations and to strive to meet these targets, achieving this target will require considerable investment in the sector, particularly in value-added agriculture.

CFA was pleased to see the Government of Canada note that "incentives are maintained so that Canada's venture capital and angel investors can continue to invest in the next generation of Canadian innovation", and that "the Government will work with the venture capital and angel investment sectors to identify how this can be best achieved."[vi] Capital flight from Canada remains a real possibility if the tax regime on passive investment income is not tailored appropriately, and CFA strongly supports this commitment to continued consultation.

Minimizing the Compliance Burden

Finally, the CFA would like to emphasize its support for the commitment to grandfather existing assets and the income resulting from them. This is critical to ensure that farm businesses' existing financial plans, for continued business viability, retirement, and succession, remain viable and that any proposals do not create significant, undue costs to replace existing plans. Differentiating between existing assets and those going forward will be a critical component of any future proposals, and it is critical that this differentiation not result in significant administrative costs or compliance burden.

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Overcoming Obstacles to Intergenerational Farm Transfers

As CFA noted in its previous submission, the proposals relating to conversion of income into capital gains would reinforce existing incentives to sell family businesses to those outside of the family and further complication succession planning for family farm corporations. CFA was pleased to see the Government of Canada announce that they would not move forward with these measures.

However, these proposals merely broadened and reinforced existing disincentives that many family farm corporations face when transferring their businesses to family members. The CFA was, thus, pleased to note the Government's commitment to reach out to farmers, fishers and other business owners over the next year to develop proposals to better accommodate intergenerational transfers of businesses while protecting the fairness of the tax system.

The CFA looks forward to working with the government on finding solutions to ensure that intergenerational transfers of small businesses are easier and less costly, while, at the same time, maintaining the integrity of the tax system. The need to better facilitate intergenerational transfers has been a long-standing priority for the CFA. The CFA has identified a short list of four areas requiring specific attention within this discussion:

1) **Ensure equal treatment for family farm transfers:** When selling company shares to a non-related corporation, a holding company is generally used. This allows the purchaser to access the acquired company's income stream and allows the vendor to access their capital gain exemption (CGE) on the sale. However, proceeds to family members are treated as a dividend, preventing to access their CGE. Section 84.1 of the ITA must be amended to facilitate access to the CGE for farm transfers to immediate family members, thus ensuring equal treatment to farm families.
2) **Update Canada's farm rollover provisions**: By replacing the word "child" in subsection 73(3) of the ITA with the phrase "family member", these important provisions would reflect and address demographic pressures facing the industry, creating opportunities for the next generation.
3) **Equitable treatment for farm siblings:** 55(2) of the ITA currently prevents sibling-owned family farm corporations from reorganizing on a tax-deferred basis —an option available to most farm family members. As farms expand, often supporting multiple households, Canada must ensure farm families have flexibility to maintain financially viability for future generations. To achieve this, section 55(2) of the ITA must deem siblings as non-arm's length for farm corporations

Conclusion & Summary of Recommendations:

The CFA is pleased to share its perspective on Finance Canada's proposals with regard to tax planning using private corporations. The CFA believes that the recent announcements made by Minister Morneau, specifically those indicating a decision not to move forward on proposals relating to the LCGE and conversion of income to capital gains, represent important steps in the right direction.

The lack of detail currently available on forthcoming income sprinkling and passive investment income measures limits the CFA to noting general areas of concern. Further review and consultation are required before any final assessments of the aforementioned proposals is possible. The following is a summary of the CFA's recommendations with regard to the proposed changes to Tax Planning using Private Corporations.

Income Sprinkling

1) Tax on Split Income (TOSI) only be applied in situations where no contribution has been made to the business;
2) If an objective contribution test is not possible, farm income should be exempt from TOSI;
3) Child-rearing activities and other indirect family contributions are important to the viability of farm businesses and should be accounted for;
4) Contributions made to holding companies and operating entities should be taken into account under any future contribution test;
5) The treatment of capital gains be closely considered to ensure income sprinkling provisions will not impede intergenerational farm transfers;
6) The Adjusted Cost Base of any farm property transferred from parent to child through existing farm rollover provisions must be considered a contribution on the part of the farm child; and
7) Implementation of any Income Sprinkling proposals be delayed to no earlier than January 1st, 2019, to allow farms and small businesses across Canada with sufficient time to assess, internalize, and respond accordingly to the new tax regime.

Passive Investment Income

8) Any taxes on passive investment income only be levied when such income is dispensed through dividends to shareholders for personal use, and not on an annual basis while they are retained within the business;
9) Farmland rental income received by an active farming business, or farmland held by the current owner within a previously active farming business, be treated as exempt from any additional tax increases imposed on passive investment income and not count against the $50,000 threshold announced;
10) Further analyze the adequacy of the passive investment income threshold of $50,000, with any such threshold treated as cumulative over time;
11) Index the passive investment income threshold to inflation to ensure the utility of this threshold is maintained over time;
12) Consult further on any future proposals, including venture capital and angel investors, to ensure unintended consequences are recognized and addressed before any such proposal comes into effect; and

13) Ensure that differentiating existing assets from those going forward will not result in significant administrative costs or compliance burden.

Facilitating Intergenerational Transfers:

The CFA has identified a short list of four key topics for discussion to ensure that the intergenerational transfer of family farms is easier and less costly, while, at the same time, maintaining the integrity of the tax system:

1. Ensure equal treatment for family farm transfers by addressing Section 84.1;
2. Update Canada's farm rollover provisions to recognize the breadth of family relations involved in modern family farming; and
3. Provide equitable treatment for farm siblings in joint ownership situations.

The CFA looks forward to the opportunity to further review more detailed proposals and draft legislation with respect to these matters. If you have any questions regarding this submission, please do not hesitate to contact Scott Ross, Director of Business Risk Management and Farm Policy at scott@canadian-farmers.ca or 613-236- 3633 ext. 2324.

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[i] Government of Canada. Budget 2017: Building a Strong Middle Class. Available at: http://www.budget.gc.ca/2017/docs/plan/toc-tdm-en.html

[ii] Government of Canada. Backgrounder: Income Sprinkling Using Private Corporations. Available at: http://www.fin.gc.ca/n17/data/17-097_1-eng.asp

[iii] Government of Canada. Backgrounder: Support for Small Business and Fairness for the Middle Class. Available at: https://www.canada.ca/en/department-finance/news/2017/10/backgrounder_supportforsmallbusinessandfairnessforthemiddleclass.html?wbdisable=true

[iv] Subsections 73(3) and (3.1) of the *Income Tax* Act allow for a tax-free inter vivos rollover of certain farm property from a parent to a child when certain conditions are met.

[v] Paragraph 70(9.01)(b) also allows the representative of a deceased taxpayer to elect to designate qualified farm property to a child at an acquisition value between the Adjusted Cost Base (ACB) and the Fair Market Value (FMV) of the property.

[vi] Government of Canada. Background: Venture Capital and Angel Investment. Available at: http://www.fin.gc.ca/n17/data/17-102_1-eng.asp