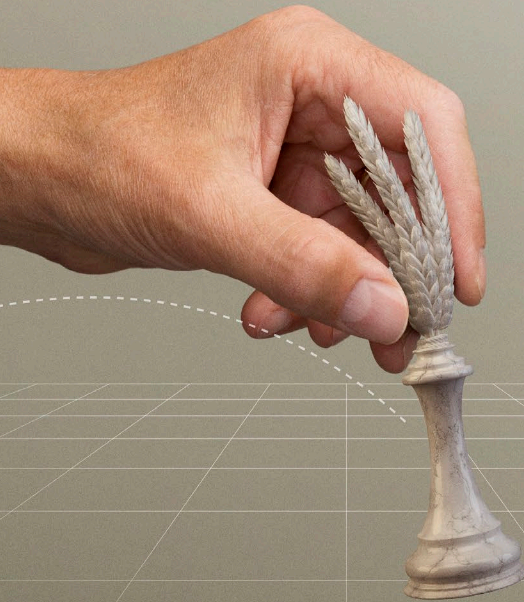

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Potential Impacts of Changing Tax Regulations on Farming Operations

On July 18, 2017, the Honourable Bill Morneau, Minister of Finance, released draft legislation and explanatory notes intended to "close loopholes and deal with tax planning strategies that involve the use of private corporations." The legislation is still in the consultation phase, but farmers need to understand the potential impacts of the changes ahead of time in order to implement any available strategies to help reduce taxes. The federal government is accepting submissions from taxpayers with their thoughts on the proposed changes until October 2, 2017.

WHAT CHANGES DO FARMERS WITH FAMILY FARM CORPORATIONS NEED TO BE AWARE OF?

There are three major areas of change that affect all private corporations in Canada, including agricultural corporations. These areas are income sprinkling (commonly known as income splitting), passive investment income and capital gains.

HOW MIGHT THE CHANGES RELATED TO INCOME SPRINKLING AFFECT FARMERS?

It is very common for family members of farming operations who are under 25 years old to be partners or shareholders of the corporation. Under the proposed new rules, having a family member under age 25 as a partner or shareholder could result in the partner / shareholder paying the top marginal tax rate on earnings if the earnings exceed a reasonable amount.

In addition, members of family farm ownership groups who are under age 25 might no longer have access to the capital gains exemption. This would apply no matter how they acquired their interest, with the possible exception being if they inherited it.

Finally, the total compensation allowed to a member of a private corporation, whether an owner or a partner, is limited under the proposed changes. Total compensation under the proposed new rules is limited to the family member's labour contribution, capital contribution and any business risk he or she has taken on, perhaps in the form of a guarantee on a loan. For a family member who purchased new common shares after a typical "freeze" transaction, this could limit the dividends on those new common shares to a "reasonable return". Although undefined, this could be perhaps a low percentage of the issue price of those shares, with dividends to the second generation in a farming corporation in excess of that amount taxed at the top marginal rate.

WHAT DO FARMERS NEED TO DO TO PREPARE FOR THE CHANGES?

Talk to your advisor early on to ensure you understand the impact of the proposed new rules on your current or planned ownership structure. Determine how they could affect your shareholders, especially shareholders who are not active in the farming operation. In addition, prepare compensation strategies that would be in line with the proposed changes as family members could end up with a significantly higher tax bill. The new rules take effect in 2018, so this may impact your 2017 compensation decisions.

HOW MIGHT THE CHANGES RELATING TO PASSIVE INVESTMENT INCOME AFFECT FARM CORPORATIONS?

Under the current proposed draft, the overall tax rate (corporate and personal) on the sale of corporate-held land or corporate-held quota may more than double, going up from 26 percent to 57 percent. In addition, income from renting land (to both family members and third parties) would be taxed at a higher rate (in some cases up to 73 percent).

WHAT CAN BE DONE TO AVOID PAYING THE HIGHER TAX?

The rules are not yet in effect, so anyone thinking of selling land or quota held by a corporation may want to do so sooner rather than later. Talk to your advisor about strategies that may mitigate the higher tax on land rental income.

WHAT ARE THE POTENTIAL CONSEQUENCES OF THE CHANGES RELATED TO THE SALE OF THE FAMILY FARM?

The proposed rules have far-reaching implications on the sale or transfer of the family farm. Farmers have the ability to transfer the farm within the family on a tax-deferred basis, as long as the farm qualifies (this is referred to as the intergenerational farm rollover provisions). This will remain the same under the proposed changes.

However, transferring the farm to a family member who does not meet the strict definition for the farm rollover provisions would result in an increased tax cost. In some cases, the result will be that the sale is taxed to the vendor as a dividend instead of a capital gain. In other cases, the use of corporate funds to pay for the farm purchase could result in taxable dividends to the purchaser.
The provisions make it much more advantageous to sell to an unrelated person than to sell to a family member. The tax costs on the death of a farmer where the rollover provisions do not apply will increase substantially.

The proposals also restrict the ability to claim the capital gains exemption on sales of family farm shares and partnerships where the vendor did not contribute adequate labour and capital, potentially limiting the ability for family members that are part-time farmers to access the capital gains exemption.

WHAT DO FARMING CORPORATIONS NEED TO DO AS A RESULT OF THIS CHANGE?

First, make sure your family farm qualifies under the rules by ensuring that at least 90 percent of your farm corporation's assets qualify as farm property. The types of assets that will disqualify your farm are land that is continually rented to third parties and term deposits or other types of passive investments owned by the corporation. Secondly, when you make your farm transition plans, you need to understand who qualifies for the transfer.

If your farm doesn't qualify or if you don't have a qualifying family member to transfer your farm corporation to, your tax bill may be higher. Make sure you talk to your advisor to avoid a double taxation situation.

WHAT CHANGES DO FARMERS WITH PERSONALLY HELD LAND NEED TO BE AWARE OF?

The proposed legislation may also impact a farmer's access to his / her capital gain exemption on land sales. Any gain on land realized while the farmer was under age 18 may not qualify for the exemption any longer. However, the government is introducing a one-time election in 2018 to help alleviate some of the impacts of this new legislation. Farmers will need to meet with their advisors this fall to gain an understanding of the rules, the impacts an election may have on their current and future tax liabilities, and then determine if an election would be beneficial for them.

ABOUT MNP

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