Tax

Management Strategies for Farmers

2nd Edition

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Preface

Farm business managers have many important factors to consider in the running of their operations. However, one of the more significant factors any farm business manager must weigh carefully is the effect taxation will have on the operation of the farm business.

To help farm business managers with these concerns, this publication will discuss various tax strategies and rules that directly affect the agricultural sector. But changes in tax law are continually being made, so this material should not be considered as an interpretation or a replacement for the legislation. Specific problems regarding tax management decisions should be referred to an accountant, lawyer or tax advisor who is aware of changes that may have happened since the preparation of this publication. Any final decision should be based on the exact wording of the law.

The material for this publication was prepared by Merle Good, Provincial Tax Specialist with Alberta Agriculture and Rural Development; and Dean Gallimore and Colin Miller, Chartered Accountants with KPMG in Lethbridge.

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Introduction

Farmers need to know that significant tax strategies are available to them. And these tools need to be incorporated into the management of the farm business. For many, tax management simply means filing their income tax returns each year. A popular goal in this activity is to get the final line on the tax form to zero.

But the bottom line means more than just that zero on the tax form. The important thing to keep in mind, as far as tax management is concerned, is that the objective should be to maximize income after tax, not just to minimize the tax obligation.

From both a business and personal point of view, the more dollars you make, the further ahead you are. As long as you take home part of the last dollar of income, it is worth earning that dollar. By looking at the after-tax financial effects of production, marketing and tax planning alternatives, you can direct the farm business towards achieving both personal and business goals.

Tax planning is generally concerned with making a choice of one or more legitimate alternatives, a choice that leads to creating the least amount of tax.

Tax planning falls into one of the following categories:

- deferral of tax
- saving of tax

Tax deferral is concerned with the timing of the payment of any tax liability and may not necessarily reduce the overall taxes paid. Such strategies as registered retirement savings plans and rollovers serve primarily to defer taxes. Generally speaking, the practice of deferring taxes does not usually upset tax officials because the Canada Revenue Agency will eventually collect the tax revenue otherwise due. A deferral of tax may, given consistent levels of inflation, lead to real savings if the future tax liability is to be paid using dollars that are not worth as much as today's dollars.

The saving of tax, on the other hand, serves to reduce the overall amount of taxes actually paid. Splitting income between husband and wife or using various business arrangements can serve in reducing the total tax bill. In comparison with tax deferral, tax savings will usually attract closer scrutiny by tax officials.

Tax planning should be a year-round activity, and it must always be balanced with sound business judgement and personal considerations. Effective tax planning requires:

- personal financial goals
- up-to-date records and financial information
- reliable long-range projection of size and source of income

Other factors to consider include the relevant tax laws, bank interest rates and inflation rates. The prime objective in tax planning should be to ensure that taxable income from any transaction either occurs or can be reported in the year it will be most lightly taxed.

When planning your affairs, it is important to keep in mind that what works well for someone else may not necessarily be satisfactory in your situation.

Keep good records because they can tell you what your specific situation is and can provide the information to decide which tax alternatives are best for guiding your farm business towards economic and personal goals.

This publication discusses the various tax strategy alternatives available for farmers. By having a basic understanding of the tax rules in relation to the farm business, you should be able to ask the right questions when considering alternatives. Should you need additional help, contact your tax advisor who is up-to-date with the tax laws.

Capital Cost Allowance (CCA)

The cost of fixed assets such as machinery, equipment, vehicles and buildings cannot be deducted as an expense in one taxation year. Instead, the expenditures are considered to be of a "capital" nature. As a result, the cost must be spread over a period of years by taking a deduction based on the cost of the asset.

The distribution of the cost of an asset over its estimated useful life is termed "depreciation." The term "capital cost allowance" is a tax term referring to the amount that The Canada Revenue Agency allows a farmer to deduct as depreciation in computing net farm income.

Under the pre-1972 tax system, farmers could choose between two methods of depreciation for calculating capital cost allowance:

Straight Line Method (Part XVII)

Under current law, the straight line method is being phased out. Assets purchased after December 31, 1971, cannot be depreciated using this method. However, assets that were owned on December 31, 1971, may continue to be written off using this method provided they have never been written off using the declining balance method.

Declining Balance Method (Part XI)

The declining balance method requires certain assets to be grouped into classes, and capital cost allowance is allowed at a prescribed rate based on the cost of assets in the class.

Dispositions of Depreciable Property

Where a depreciable asset is sold or traded, the proceeds of disposition up to the original capital cost reduce the tax base of the assets of the particular class to which the asset belonged. As a result, the capital cost allowance for the year will be lower than it otherwise would have been. If the proceeds are greater than the tax base of the class, the excess is called "recaptured capital cost allowance." Under the declining balance method, the full amount of recaptured capital cost allowance is included in farm income.

A "terminal loss" is just the opposite of recapture. It results when all declining balance assets are sold for proceeds less than undepreciated values of the assets of that class - a balance remains in the class; however, there are no assets remaining. A terminal loss is fully deductible from farm income in the year it arises.

Tips and Traps

Flexibility of CCA Claim

✓ A farmer can choose to make a capital cost allowance claim for any amount up to the maximum percentage for that class.

✓ In a year where a farmer does not need to use the maximum deduction, a good strategy may be to choose to take CCA on the classes with the lowest maximum write-off rates. This strategy ensures that the balance in a higher rate class can be preserved and a larger CCA claim will be available in the subsequent year (where maximum claim may be beneficial).

✓ In some instances, it may be useful to claim full CCA in the current year and claim an amount of Optional Inventory Election (OlE) to bring income to a desired level. In the next year, both OlE and CCA can be deducted.

Tips and Traps – continued

Available for Use Rules

✓ CCA may only be deducted on assets available for use at the end of the taxation year. For other assets that may have been purchased but aren't actually available for use, CCA may not be claimed until the year in which the assets are actually available for use. For example, a combine purchased in the fall that is yet to be manufactured would not be eligible for CCA as it is not yet available for use. (Note: this regulation does not require actual use, just that the asset must have been available for such use.)

Half-year Rule

✓ In the year that a depreciable asset is acquired, the maximum CCA that can be claimed on that asset is limited to one-half the regular CCA.

✓ The half-year rule applies to net additions. Where the farmer disposes of equipment, the restricted CCA claim will only apply to the cost of the assets acquired less the disposal proceeds deducted from the CCA pool.

✓ If the farmer is acquiring assets, the CCA claim is the same whether the asset is acquired early or late in the year (assuming it is available for use). Therefore, assets acquired near the end of the year still result in a CCA claim for the year.

✓ The half-year rule does not apply to a non-arm's length acquisition (if owned at least one year before the end of the year in which the farmer acquired it).

Classes 1-12 Election

✓ The *Income Tax Act* provides an election that allows the farmer to transfer property from Classes 2 to 12 into Class 1.

✓ The effect of this election is that property is transferred into Class 1 prior to reporting the disposition which will allow the farmer to defer potential recaptured depreciation on a disposition.

✓ The remaining assets must stay in Class 1 until they are disposed of and will be depreciated at a significantly lower rate (4 per cent).

✓ Future additions are added to the appropriate class.

For example:

	Undepreciated Capital Cost
Class 6	25,000
Class 8	75,000
Class 10	45,000

Farmer disposes of Class 10 assets for proceeds of $120,000 (original cost $120,000).

Normally, this would result in taxable recapture in Class 10 of $75,000. By electing to transfer all Class 6, 8 and 10 assets into Class 1, the sale of all the former Class 10 machines could defer the potential recapture of CCA that such a sale would otherwise have attracted. The CCA schedule would be as follows:

	Opening	Transfers	Disposals	Ending
Class 1	0	145,000	120,000	25,000
Class 6	25,000		(25,000)	0
Class 8	75,000		(75,000)	0
Class 10	45,000		(45,000)	0

The assets sold to any purchaser (arm's length or non-arm's length) would be depreciated in the appropriate capital cost allowance class on an asset by asset basis.

Tips and Traps continued

Year of Death

✓ In the year of a farmer's death, the Canada Revenue Agency deems the farmer to have disposed of all depreciable assets for proceeds equal to Fair Market Value. In certain cases, property may qualify for a rollover to a spouse or child, and in those cases, there would not be a deemed disposition.

Rollover to Children

✓ A farmer can transfer depreciable assets to a child at undepreciated capital cost (UCC) without triggering any recaptured depreciation or capital gain.

✓ This rollover of depreciable property can occur if the following conditions are met:

1. the property is Canadian property
2. before the transfer, the property was used by the taxpayer, spouse of the taxpayer, parent of the taxpayer or a child of the taxpayer principally in the business of farming in which the taxpayer, taxpayer's spouse or child of the taxpayer was actively engaged
3. the child is a resident of Canada

For more information, see section on Rollovers.

Year of Transfer/Rollover

✓ In the year of transfer (e.g. by Section 85 rollover), the transferor cannot claim CCA as the assets are not owned at the end of the year (even if transfer occurs on the last day of the year).

✓ Consider delaying rollover to early in the next year to get CCA for the current year.

Short Fiscal Period

✓ In the year of incorporation or initial year of farming, a farmer may have a reporting period that results in a short taxation year for the first year.

✓ CCA must then be prorated based on the number of days in the taxation year.

Reserves

✓ In the year of disposition, recaptured depreciation may be created.

✓ Normally a reserve may be used in a sale where proceeds are due over more than one year; however, a reserve is not available on recaptured depreciation.

Large Trucks

✓ A truck or tractor designed for hauling freight and that is primarily so used by the taxpayer or a non-arm's length person in a business that includes hauling freight qualifies as a Class 16 asset. It is depreciated at 40 per cent if the vehicle has a gross vehicle weight rating in excess of 11,788 kg. Many large farm trucks may qualify for this higher depreciation rate.

Year End Deferrals

Businesses are generally required to follow the “accrual method” of accounting for income. The accrual method requires an adjustment to net income for sales in the year even though cash may not have been received, and expenses incurred but not paid for.

Farmers have an alternate method for accounting for income; the “cash method.” The cash method means the cash received rather than the sales will be reported as income, and only cash payments that have been made will be deducted as expenses. Farmers can use either the cash or accrual methods for calculating income.

Generally, the cash method provides a certain amount of deferral of income and may result in lower tax payable. Accrual farm records or accrual adjustments to cash records provide more financial information about the farm business.

Once the cash method is chosen, the farmer is required to use that method for all future years unless granted permission to change by the Canada Revenue Agency.

Tips and Traps

Deferred Cash Grain Tickets

✓ The use of the "deferred cash grain ticket" is a means by which crop inventories can be sold in one year but not taxed until the subsequent year at the discretion of the farmer who reports on the cash basis.

✓ When grain is delivered to a licensed public elevator or process elevator, a storage ticket, cash purchase ticket or a deferred purchase ticket may be issued. If a storage ticket is issued, no sale has taken place; therefore, income has not been received at that time. If a cash ticket is received, the sale has taken place, and the farmer is considered to have received payment at that time regardless of when the ticket is presented for payment. If a deferred cash purchase ticket is issued, and the ticket provides for a payment date after the end of the fiscal year in which the grain is delivered, the income for the ticket may also be reported in the following fiscal period.

Using Deferred Cash Grain Tickets to "Pay" For Expenses

✓ In a technical interpretation dated September 16, 1996, the Canada Revenue Agency commented on a situation where a farmer transfers a deferred cash grain ticket (DCGT) to a supplier, and the supplier accepts the DCGT as a payment on a purchase.

The Canada Revenue Agency’s view was that even though the farmer has a "constructive receipt" on transferring the DCGT to the supplier, Subsection 76(4) still allows the deferral of the income under the DCGT. In this manner, the farmer could deduct the expense in the current year that was paid for by the DCGT and yet not report the income under the DCGT until the following year (as if the farmer had simply maintained the DCGT).

Advances Under the *Advance Payments for Crops Act* or *Prairie Grain Advance Payments Act*

✓ Cash advances received are not taxable receipts and are treated as loans. The sale of grain to repay the advance should be reported in farm income at the gross amount before the reduction for the repayment of the advance.

Tips and Traps – continued

Deferred Cash Grain Tickets in Conjunction with a Grain Advance

✓ Consider a situation where a farmer takes out a qualifying advance and subsequently delivers grain prior to his or her fiscal year end. If the farmer then receives a deferred cash grain ticket subject to a deduction to repay the advance, the question arises about which fiscal period the part of the sale regarding the advance must be reported.

✓ The Canada Revenue Agency has clarified its position by stating that providing the deferred grain ticket meets the requirements of the Interpretation Bulletin 184R and the entire proceeds of the sale are deferred until the deferred cash ticket is negotiable. The primary requirement presently is that no interest shall be paid to the holder of the deferred cash ticket.

✓ For example, a $50,000 advance is taken. Twenty-thousand dollars worth of grain is delivered with $18,000 being deducted and applied against the advance. The remaining $2,000 is deferred until the next fiscal period. For tax purposes, the entire $20,000 (the value of the deferred grain ticket) will be reported in the following year.

Prepaid Supplies

✓ A farmer may make a payment on account at one of his suppliers and leave this payment as a credit towards purchases to be made in the subsequent year. A credit payment on an account does not qualify as an expense in the Canada Revenue Agency view. Therefore, for a payment to be considered a deductible expense in the year made, actual supplies should be purchased.

Deferred Livestock Sales Through a Public Auction Mart

✓ In a technical interpretation dated September 16, 1996, the Canada Revenue Agency commented on the sale of livestock through a public auction mart where a farmer asks the auction mart not to pay him or her until the farmer's subsequent taxation year. The Canada Revenue Agency Revenue's view was that since an auction mart acts as an agent for the farmer in selling the livestock, the farmer is paid on the date the purchaser pays the auction mart, even if the auction mart holds the funds for a time before paying the farmer.

Deferred Agricultural Commodity Sales

✓ It is relatively common for farmers who report income on the cash basis to request income from the sale of various commodities to be deferred to their next fiscal period by way of a post-dated cheque. In addition to the adverse security position taken by the farmer, the Canada Revenue Agency has indicated verbally that it has concerns with such transactions when the purchaser was clearly in the position to pay for the products, and therefore they may require the payment to be included in income at date of sale.

Inventory

✓ Cash expenses can be increased by making purchases of inventory resulting in a subsequent reduction of farm income. Farming losses, however, cannot be created through the same purchase because of the Mandatory Inventory Adjustment (MIA) rules. See the discussion in the Farm Losses section.

✓ Be cautious of an increasing tax deferral over several years. Consider the example where a farmer has adopted the strategy of purchasing inventory to bring income to nil each year. Assuming a profit before the purchase is earned each year, the farmer is

Tips and Traps – continued

simply pushing the income forward to the future. At the time the farmer wants to get out of the business, a significant deferral may have accumulated, and a significant tax liability may be incurred. Think about adopting a strategy where at least the low rate of tax is paid each year to smooth the tax liability over several years.

✓ A farmer may use an optional inventory election to include in income any amount up to the fair market value of all inventory on hand at the end of a given year. The amount will then be deductible in the following year. Consider this strategy where the current year income is low, and anticipated income for the next year based on inventory at the end of the year is higher. The election will enable the farmer to access the maximum lower rate of tax over two years.

For example:

Without Election

	This Year	Next Year
Farming income	$10,000	
Farming income (based on year end inventory)		$100,000
Tax payable	**$ 875**	**$ 36,275**

With Election

	This Year	Next Year
Farming income	$10,000	$100,000
Optional inventory adjustment	40,000	(40,000)
Adjusted income	50,000	60,000
Tax payable	**13,875**	**17,875**
Total tax savings	**$ 5,400**	

Farm Losses

Regardless of what type of farming activity individuals undertake, they are only allowed to write off losses for tax purposes if they are engaged in the business with a reasonable expectation of profit. The income tax act classifies people engaged in farming in three different categories. The principal difference among these groups is the extent to which they can deduct losses relating to their farm activities.

Full-time Farmer

An individual whose chief source of income is farming is considered a full-time farmer. Such individuals are allowed to treat their farming business like any other business. As a result, they can claim losses against other income for tax purposes if they suffer losses in any given year.

Hobby Farmer

Those individuals who do not have a reasonable expectation of profit from their farming activity are referred to as hobby farmers. Hobby farmers cannot deduct losses from their farm activity at all.

Part-time Farmer or Restricted Farming Losses

Farmers who have a reasonable expectation of profit but whose “chief source of income” is neither farming nor a combination of farming and some other source of income are restricted in the amount of loss they can deduct.

Tips and Traps

Mandatory Inventory Adjustment (MIA)

✓ In the year that a cash loss occurs, the farmer is required to decrease the loss to the extent that inventory was purchased and is still on hand at the end of the year. The adjustment to the loss is referred to as the Mandatory Inventory Adjustment (MIA) and is a required adjustment that will be applied to purchased inventory only in a loss year.

✓ The amount of the MIA will be the lesser of:

1. the net farm loss calculated on a cash basis (including recaptured depreciation and capital cost allowance) and
2. the value of purchased inventory on hand at year end (valued at the lower of cost or market value) unless Specified Animal rules apply.

Optional Inventory Adjustment

✓ Farmers operating on a cash basis may include in their income for a year any amount up to the fair market value of their inventories on hand at the end of the year. In the subsequent year, a deduction equal to the optional inventory added in the previous year is made.

✓ An optional inventory adjustment should be considered in a very low income year providing you can determine that the following year farm income will be substantially higher. The adjustment could reduce the amount of income that would be subject to a higher rate tax.

Restricted Farm Losses

✓ For farmers with a reasonable expectation of profit but whose chief source of income is not farming, the use of their losses against other income is restricted. The loss allowed is $2,500 plus one-half of the next $12,500 to a maximum of $8,750. The portion of the loss not deductible currently under this restriction is available for carry-forward and can be used in the future against any farm income (20 year carry-forward). It could be carried back to reduce farm income reported in any of the three previous years.

✓ Mandatory Inventory Adjustment (MIA) must be calculated before claiming a loss or a restricted farm loss.

Creating a Loss with Specified Animals

✓ In general, a farmer will be denied a loss attributable to purchases of inventory (see Mandatory Inventory Adjustment). However, for horses and certain registered bovine animals, a portion of the loss may be deducted. (Note: bovine is not a zoological term; it implies cattle and oxen.)

✓ For the purposes of the mandatory inventory adjustment, inventory is generally valued at the lower of cost or fair market value; however, the taxpayer may elect to value "specified animals" on a diminishing balance basis.

✓ A farmer may choose to value a "specified animal" at 70 per cent of the total of its cash cost or at a greater amount not exceeding its cash cost. For a year subsequent to its acquisition, the animal may be valued at 70 per cent of the total value determined at the end of the preceding year or at a greater amount not to exceed its cash cost.

For example:
Assume the only transaction in the year was the purchase of registered bovine animals for $50,000.

The cash basis loss for the farm business would be $50,000. Under the mandatory inventory adjustment (MIA), the add-back required for

Tips and Traps – continued

tax purposes would be $35,000, resulting in a $15,000 loss for tax purposes that could be used to offset other income.

(Note: depending on specific circumstances, it is possible this loss could be subject to restricted farming losses as discussed in the Farm Losses section.)

Loss from farming:	($50,000)
MIA ($50,000 X 70%)	$35,000
Loss from farming	($15,000)

In the second year, assuming no sales and another purchase of $40,000 of registered cattle, the cash basis loss would be $75,000 ($40,000 purchase less the prior year inventory inclusion of $35,000). The mandatory add-back of purchased inventory would be $52,500 (70 per cent of $40,000 purchase and 70 per cent of the mandatory add-back for the previous year of $35,000).

For the second year, therefore, a $22,500 loss would exist that could be used against other income (also possibly subject to restrictions discussed in the Farm Losses section).

(Note: this assumes a reasonable expectation of profit exists for the operation.)

Loss from farming:		($40,000)
Previous MIA:		($35,000)
Cash basis loss:		($75,000)
Current MIA:		
($40,000 X 70%)	$28,000	
($35,000 X 70%)	24,500	
Total:		$52,000
Adjusted cash basis loss:		$22,500

Inventory

Transfer to a Child During a Farmer's Lifetime

Inventory does not qualify for any "rollover" provision; therefore, a transfer will deem a sale to have occurred at fair market value. The taxpayer will be deemed to have received fair market value for the inventory transfer while the recipient will be allowed an offsetting expense.

Tips and Traps

✓ To complete the transfer on a reduced tax basis, the inventory could be sold to a child for a debt due over a period of time with or without interest. This approach would effectively provide a "reserve mechanism." The child would pay the sale proceeds over time to the parent, resulting in taxable income (assuming the cash basis of income reporting) as received by the parent and a corresponding deduction for the child.

✓ This strategy would allow immediate transfer of the inventory while spreading the income out over more than one year. Care should be taken in structuring this sale. A transfer of inventory (e.g. cattle) that may only be held for two or three years by the child but for which the payments will be made to the parent over a long period might cause concern with the Canada Revenue Agency.

✓ It may be possible for the parent to subsequently gift part of the cash back to the child if that is the parent's desire. (A gift of cash to a child who has reached the age of majority would not normally constitute forgiveness of the debt or be subject to

Tips and Traps – continued

attribution. Forgiveness of the loan could cause the loan to be considered to have been paid. See section on Forgiveness of Debt.)

✓ Transfer inventory as a payment in kind for labour on the farm - if farm inventory is transferred to a child as payment for farm labour, the parent should technically report a sale of the inventory and also a salary expense (which could result in a requirement for payroll deductions and reporting). The child, technically, would report the salary income and then also show a purchase of farm inventory. Any subsequent sale of inventory by the child would be taxed in the child's hands.

Transfer on Death

Inventory can be transferred on a tax-deferred basis by a will under a special provision related to “rights or things.” Under this provision, inventory can be left to any named beneficiary, and the beneficiary will pay tax on the inventory when it is sold. This method effectively achieves a rollover of inventory on the death of the taxpayer. (Note: other options exist for rights or things including the possibility of reporting them on a separate tax return of the deceased.) There are no restrictions on transfers of rights or things to beneficiaries.

Tips and Traps

✓ A strategy to consider is to combine a note payable with the special rights or things provision. The taxpayer could sell the inventory to a child and through a will, forgive the balance owing on the note. There are no adverse tax consequences with this strategy, and the child will now inherit the cattle with the note being extinguished. (Note: there would be no deduction on the part of the child for the inventory.)

✓ This type of plan might be best used where the parent has a serious health problem (and the impact of the general anti-avoidance rule must always be considered).

Transfer to a Company

Where a farmer wishes to incorporate a farm business, business assets such as inventory may be transferred to a corporation without incurring an immediate tax cost. Inventory may be transferred by an individual to a corporation at any amount between cost and fair market value if the appropriate income tax election is filed under Section 85 of the *Income Tax Act* and assuming that all necessary conditions are met.

Tips and Traps

✓ An election form must be filed with the Canada Revenue Agency to record the transaction for tax purposes.

✓ Electing at any amount above cost will result in income to the transferor.

✓ To avoid tax, it is often necessary to elect on inventory at an amount of $1 for the purposes of the transfer to the company. This means that only $1 of debt can be transferred into the company on the rollover. Attempts to have the company assume more debt on the inventory transfer would result in an automatic increase in the elected amount and resulting tax. It may, therefore, be necessary to also transfer other farm assets that have cost base to allow debt

Tips and Traps continued

to be assumed by the company without negative tax consequences.

✓ Accounts receivable such as deferred grain sales (e.g. deferred grain tickets) cannot be transferred into a company. The income from the receivable could be offset by an inventory purchase that could be transferred to the company on a subsequent Section 85 transfer. One unique strategy is to exchange a deferred grain ticket for a storage ticket (which results in income and an offsetting expense). The storage ticket is inventory which can be rolled into the company.

Example of personal vs. corporate tax rates on sale of inventory

Assumed Inventory on Hand	$150,000
Personal Tax on Inventory (assuming Alberta resident with $30,000 of other farm income and no other income)	$56,000
Corporate Tax (assuming business income eligible for the small business deduction in Alberta)	$21,000
Potential Tax Deferral	**$35,000**

Cattle Lease

Leasing has become very popular for many types of property. Cattle leases are also available to farmers. Common types of cattle leases are:

- Cash lease - cash rent per cow per annum. Operator accepts all production and market risk.
- Fixed number of calves lease. Owner receives a predetermined number of calves as rent (not based on numbers born, weaned or sold).
- Percentage share lease. Each party receives a predetermined percentage of revenue from the sale of calves.
- Flexible share lease. Allocates revenue based on contributions to costs. For example, perhaps the first $300 of revenue per cow is allocated to the lessee to cover direct costs. Perhaps the next $100 is allocated equally to recognize the capital costs (of the cows for the lessor and of the facilities for lessee) and the balance of revenues is allocated based on a negotiated basis (e.g. 80 per cent to the lessor and 20 per cent to the lessee).
- The best lease for the situation depends on the amount of risk the lessor and the lessee are each willing to bear.

Advantages of Cattle Leasing

- Reduce herd to more manageable levels without immediate sale.
- Another alternative as part of an estate plan in transferring farm assets.
- Maintain ownership of animals without day-to-day responsibilities.
- Allows child to reap some of the rewards of a cattle operation without laying out significant cash to purchase animals.
- Effective way for an operator with excess capacity to ensure use of facilities.

Disadvantages of Cattle Leasing

- Possible lower returns for owner due to poor management by lessee.
- May limit liquidation options.

Tips and Traps

✓ Issues to consider when drawing up a cattle lease:

- description of cattle, brand and arrival date
- location of cattle (e.g. where to be kept and rights of inspection)

Tips and Traps continued

- breeding policy (which party provides the bull, authority for selecting the bull, timing)
- veterinary policy (who pays for vet bills, any practices to be followed to ensure herd health)
- culling and replacement policy
- death, loss and strays (who bears cost)
- division of income
- termination of lease (timing and rights for early termination)

Transfer to Child

Farming parents often wish to gift their inventory to their children. While farming inventory may be given away, one must consider the tax consequences. The farm rollover provisions allow for the transfer of land, buildings, equipment and quota on a tax deferred basis to children, but this provision does not apply to inventory.

The general rules of the *Income Tax Act* deem that when a farmer gives away inventory, he/she is considered to have sold the inventory for its fair market value, and tax will likely result.

There is some question of whether the recipient child would be entitled to a deduction on the cash basis. Therefore, it may be better to structure the transfer as a sale with the outstanding debt to the parent forgiven under the terms of the parent's will.

Tips and Traps

✓ Alternatives to be considered:

Agreement for Sale - Producer Note

- An Agreement for Sale is put into place between a parent and child for a sale over a period of time. If both the parent and child are filing on the cash basis, the parent would report income when received and the child would get a deduction when paid.
- The term of agreement should not exceed the expected lifetime of the assets sold (e.g. maximum seven to ten years for a cow herd).
- There is the concern that the Canada Revenue Agency might view this arrangement as a complete sale by the parent in year one with fully taxed proceeds. This assumption is on the basis that the child is receiving 100 per cent of the economic benefit of the cow herd, even though only a portion of the purchase price is paid in year one. Refer to the next section to avoid this concern.

Lease Agreement - Option to Purchase

- A lease could be entered into that also gives the child the option to purchase, at any time, a certain percentage of the parent's remaining cattle herd. The purchase price can be set at the inception of the lease or negotiated on a yearly basis. In this situation, the parent would be entitled to an annual cow lease payment or calf crop share, based on bred cows remaining.
- If entering into this type of lease arrangement, the cash outlay by the child must be considered since the parent will be receiving a lease payment or calf crop share plus full cow receipts and purchase payment from the child.

Transfer to a Partnership or Corporation

- Consider rollover election and transfer to a partnership or corporation in which the child is involved.

Tips and Traps continued

- If a corporation is used, the parent might take back preferred shares and have the child subscribe for all the common shares to effect a freeze.
- The question might be raised, can a farmer transfer say $250,000 worth of cattle to a newly-formed corporation and then immediately sell the corporation to the child and incur a capital gain that would be sheltered by the enhanced capital gains exemption? Unfortunately, this situation has some risk.

Normally, Section 54.2 of the *Income Tax Act* provides that for the share to be deemed to be capital property, the property transferred to the corporation must be all or substantially all of the assets used in active business prior to incorporation. Therefore, this condition would require a transfer of more than 90 per cent of all the farming assets (not just inventory). A similar result would likely occur for a partnership.

Feeder Association Purchases

Farmers may use a feeder association to purchase their cattle inventory. Where the feeder association is used, a farmer will generally not be required to make a full cash payment for the cattle. The association will issue a note that the farmer will extinguish when the cattle are sold.

Generally, the cattle are branded with the feeder association brand for security purposes. Although the farmer does not have a cash outlay for the full amount of the cattle purchased, a deduction can be taken for the full amount of the cattle purchased in the current year. (Mandatory inventory adjustment rules still apply.)

Grain Storage Arrangements

Currently, some companies are structuring arrangements that allow a farmer to use a storage facility constructed by the company at or near the point of grain delivery, such as an elevator. Some have been structured as an actual purchase of a condominium interest in the storage facility, some as leases and others financed by refundable deposits made by the farmer. The tax treatment of each of these arrangements must be considered separately.

Condominium Interest

A purchase of a condominium interest in a grain bin would normally be treated as the acquisition of a portion of a bin and, therefore, be treated as a depreciable asset. Normally, the acquisition of a building (or portion thereof) on land leased from another party may be considered as a Class 1, 3 or 6 asset pursuant to Regulation 1102(5). Alternatively, if the condominium interest is not captured by this regulation, the asset may be a leasehold interest subject to depreciation under Class 13.

Leasing of Bin Space

A contract to simply lease space for an annual payment would likely be considered a straight expense. Caution must be exercised, however, where the lease is very long term and might be considered a capital lease by the Canada Revenue Agency. That would seem unlikely in this sort of situation but should be considered since it would result in the acquisition of the asset for tax purposes. Such a result would mean that the tax treatment would be the same as outlined above for condominium interests.

Refundable Deposits

A review of a current arrangement being offered by a company showed that the use of the facility was offered to farmers based on the payment of a refundable deposit. This payment was fully refundable at the end of the 15-year term or earlier (in the case of an early termination). There were no annual costs. From an income tax perspective, it is unlikely any deduction or capital cost allowance claim would be allowed in this type of arrangement since the cost will be fully refunded upon termination.

Farm Wages

A farmer can deduct reasonable wages and wage costs paid to family members from farming income.

Tips and Traps

✓ Canada Pension, income tax and perhaps employment insurance deductions must be withheld and remitted by the employer. Note that Canada Pension need not be withheld for individuals under the age of 18.

✓ The employer is also subject to employer contributions of Canada Pension and employment insurance.

✓ Generally, withholdings for Canada Pension Plan (CPP) start at $3,500 of annual wages and income tax at about $10,300. Employment insurance (EI) premium withholdings may also be required.

Farm Wages Paid to a Spouse

- Wages may be paid once a year to minimize paperwork.
- Wages will only be deductible if they are reasonable, based on the work performed. Such services may include bookkeeping, filing, other administrative work, picking up supplies or general farm labour, and the salary should be similar to that which would be paid to arm's length party for the same services. The fact that family members may be on 24-hour call to provide these services may assist in supporting a more than nominal salary.
- Payment of wages to family members will provide earned income that will allow them to contribute to a Registered Retirement Savings Plan (RRSP).
- Where the spouse is employed on other than usual terms of employment, it may be possible to save the employee and employer portion of employment insurance on wages paid to a spouse.
- Very often this is so in a farm-spouse situation since it would be difficult to find a suitable replacement employee to perform all the tasks required from the spouse at any time of the day or night. Such tasks may include running to get supplies, helping with general farm labour, bookkeeping and preparing meals for hired hands. In addition, the terms of employment are often arranged to have payment of the salary once a year, and it would be difficult to attract third-party help under these circumstances.
- Caution must be taken to ensure the salary is not unreasonable - an unreasonable salary would render it not deductible for income tax purposes.
- Each situation should be evaluated carefully, and a ruling from the Employment Insurance Commission could be obtained to determine whether the salary is insurable or not. This ruling can be requested by completing Canada Revenue Agency form CPT-1 (08). If a ruling is received that employment is not insurable and employment insurance premiums have been paid in the past, a request for a refund of those premiums can be made using form PD24.

Hiring Employees vs. Contractors

The difference between hiring an employee and a contractor is important for several reasons:

- An employer must withhold source deduction amounts for tax, Canada Pension and employment insurance for an employee.
- A penalty and interest may be assessed for failing to withhold these amounts. Generally, the Canada Revenue Agency would go back at least three years in assessing these withholdings and associated interest and penalties.
- If an individual is assessed as an employee and does not pay the required income tax, the Canada Revenue Agency is entitled to recover this amount from the employer.
- If the relationship is determined to be one of employment, then the worker will be restricted in deducting only those expenses allowed for employees under Section 8 of the *Income Tax Act*.
- Goods and Services Tax applies to payments made to contractors (unless they are a small supplier) but not to payments made to employees.

Whether an individual is engaged in a “contract of service” (employment) or a “contract for services” (independent contractor) is a common law concept that has evolved over the past few centuries. There is no set rule in any legislation to assist in deciding whether it is better to hire employees or contractors. It is best to study the individual circumstances of each situation.

If payers or workers are uncertain whether the Canada Revenue Agency views the relationship to be one of employment, they may apply to Source Deductions at the District Office on form CPT1 for clarification. This step would eliminate the uncertainty, but experience shows that the Canada Revenue Agency has a predisposition to find these relationships to be ones of employment.

Payroll audits often result where a former worker applies for employment insurance (to which an independent contractor would not be entitled) and claims that the worker should be entitled to employment insurance benefits.

The courts seem to have developed four traditional tests to determine whether a worker is an employee or a contractor:

- control
- ownership of tools
- chance of profit or loss
- integration

While none of these tests alone determines whether employment or contractor status exists, the Canada Revenue Agency seems to focus on the control test.

Some of the favourable factors for contractor status include:

- written agreement
- own equipment used
- own overhead expenses
- investment of some capital
- payment on presentation of invoice
- non-exclusive contract
- other business income sources
- not required to do tasks personally
- discretion with regard to the amount of work done, when and how it is done

Some of the unfavourable factors for contractor status include:

- payment at payroll intervals
- set hours of work
- paid vacation time
- liability for acts assumed by employer
- use of company vehicle
- services performed at work place
- little control over how work done
- entitlement under employee benefit plans

A T4 should not be prepared for a contractor.

Home Offices

Self employed farmers can write off all eligible home office expenses. These expenses include rent, mortgage interest, property taxes, utilities, telephone, outside maintenance, minor repairs and supplies, and home insurance. The eligible portion of the expense is based on the fraction of the house used for the office (based on square footage). The 25 per cent rule of thumb used by many farmers could be subject to challenge by the Canada Revenue Agency.

Tips and Traps

✓ A deduction for home office expenses is allowed only if the following two conditions are met: the home is the principal place of business, or it is used on a regular and continuous basis for meeting clients or customers.

✓ Home office expenses cannot be used to produce a loss. However, losses disallowed because of this rule can be carried forward and used in any later year against income generated from the same business .

✓ If capital cost allowance is claimed on a fraction of the house, the principal residence exemption may be disallowed (potentially on the entire house value).

Farm Houses

Farmers have the option of owning their house personally or through a farming corporation. If the farmer owns the house personally, a reasonable portion of light, power, water, telephone and fire insurance is deductible as a farm expense. A reasonable portion of house repairs are also deductible. Capital cost allowance may also be taken on the dwelling in proportion to the business portion of the house.

Tips and Traps

✓ As noted above, a capital cost allowance claim on a farm house may disqualify the farm house for the principal residence exemption (potentially on the entire house value).

✓ Although the house is personally owned, expenses related to the house may be paid through the farming corporation. The proportion of the expense such as utilities or property taxes relating to personal usage should be charged back to the shareholder. This can be done by way of a charge to the shareholder loan account, or as a wage to the shareholder or as a taxable benefit.

✓ A farmer may also personally own farm buildings other than the principal residence. As an alternative to having the farming corporation pay rent to use the building, the corporation could pay the insurance cost for the building on the farmer's behalf, in lieu of rent. Technically, a rental statement would be required, but presumably the rent would be offset by the capital cost allowance and other expenses.

Tax Treatment of Farm Family Home

While most capital gains are subject to tax, any gain that an individual realizes when a principal residence is sold is still tax free in most cases.

What is a principal residence for tax purposes? Generally, it is a housing unit ordinarily inhabited in the calendar year by the taxpayer, the taxpayer’s spouse or former spouse or by a child of the taxpayer. The housing unit will include only that land which “contributes to the use and enjoyment of the housing unit.” Up to one-half hectare will be accepted without question.

If the claim states that more than this one-half hectare contributes to the "use and enjoyment," then the Canada Revenue Agency may challenge the claim. Several factors will be considered in allowing such a claim - see paragraphs 15 to 17 of Interpretation Bulletin 120R6.

What Special Alternatives Exist for Farmers?

The *Income Tax Act* allows a farmer two ways to calculate the exemption from the capital gains tax on the principal residence when the property is disposed of.

Under the first method, the farm can hypothetically be divided into two sections. One section will be the farm house plus one-half hectare (or more if necessary to contribute to the use and enjoyment). The other section will be the rest of the farm property. A reasonable allocation of the sale proceeds must then be made between the two parts. The capital gain on the principal residence portion will most likely be exempt from tax, and the rest of the property will be treated in the normal manner for capital gains and recapture of depreciation.

Under the second method, the farmer will not have to segregate the principal residence portion of the property. Instead, to arrive at the capital gain, the selling expenses and the adjusted cost base are subtracted from the total proceeds. The capital gain can be reduced by an amount equal to $1,000 plus $1,000 for every year that the house has been the farmer's principal residence since December 31, 1971. Part years count as full years for this purpose. To take advantage of this second method, a farmer must file a special letter with his or her tax return that sets out certain information concerning the property.

Can a Husband and Wife Each Have a Principal Residence?

Prior to January 1, 1982, it was possible for a husband and wife to each designate a home as a principal residence and have any capital gain on the house exempt from tax.

After December 31, 1981, a family unit may designate only one property for any year after 1981. Where a family unit owned two properties on December 31, 1981, any capital gains on the properties to that point may be exempt from tax, but the gains on only one property will be exempt after that date.

Can a Farm Corporation Own the Family Home?

The tax exempt status of the principal residence is lost for company-owned homes.

Can a Parent and Child Each Have a Principal Residence on the Farm?

In many situations today, a parent and a child are jointly farming the same farm where each has a principal residence. In determining whether or not two principal residences can be designated, the concept of ownership is important. Each may designate a principal residence if they both own the farm property as tenants in common or joint tenants. Only one principal residence may be designated if either the parent or the child owns the farm.

Can a Partnership Have a Principal Residence?

Interpretation Bulletin 120R6 indicates that a partnership is not a taxpayer and cannot use the principal residence exemption. However, a member of the partnership could use the principal residence exemption to reduce or eliminate the portion of any gain allocated to that partner (assuming the partner resided in the residence for the years in question).

Motor Vehicles

As a general principle, a farmer can deduct the proportion of automobile expenses that represent business use of the automobile. However, complex rules exist where the vehicle is a type other than a "normal" half-ton truck used primarily for transportation of goods and equipment (e.g. an extended-cab truck). These types of vehicles are referred to as passenger vehicles. Vehicles such as a van or an extended-cab truck can be excluded from the passenger vehicle restrictions if certain conditions apply (see Tips and Traps below).

Passenger Vehicles

Limits have been placed on the deductibility of automobile expenses for tax purposes. The objective of these limits is to restrict the deductibility of automobile expenses for higher priced cars, specifically automobiles costing more than $30,000.

Automobile costs can be divided into two components: the capital cost and the operating cost of a car.

The capital cost of a passenger vehicle is set at a maximum of $30,000 for the purpose of claiming capital cost allowance. The $30,000 limit represents the full cost of the vehicle excluding Goods and Services Tax (GST). Any other additions to the car, such as a roof rack, should not be included in the cost of the car.

Each passenger vehicle costing more than $30,000 (before GST) must be put in a separate class (Class 10.1). The amount added to the capital cost allowance pool is limited to $30,000 plus the related GST calculation on the maximum amount of $30,000 so that the capital cost allowance claim (30 per cent declining balance, ½ capital cost allowance claim in the year of acquisition) is computed on this base. Vehicles costing less than $30,000 are included in Class 10.

When the Class 10.1 automobile is sold, the proceeds will be used to reduce the pool balance. A terminal loss cannot be claimed if the proceeds are less than the remaining pool balance. If the proceeds are greater than the pool balance, there is no recapture included in income. In the year of disposition, a taxpayer is permitted to claim one half of the normal capital cost allowance if the car was used to earn income at the end of the immediately preceding taxation year.

Leasing

Even if a car is leased instead of purchased, the deductibility of the lease payment is limited. The deductibility of the lease is limited to the lessor of

A. the actual lease payment,

B. $800 per month or

C. the actual payment times 30,000 divided by 85 per cent of the vehicle cost.

There are also provisions to reduce the deductible lease payments further for interest earned on refundable lease deposits and reimbursements.

Tips and Traps

- ✓ In summary, if the automobile is a passenger vehicle (a vehicle that carries passengers in excess of the driver and two other passengers), the amount of the purchase price which can be added to the capital cost allowance pool is restricted to $30,000. This does not include regular half-ton trucks as long as the truck is used primarily (more than 50 per cent) for the transportation of goods or equipment in the course of gaining or producing income.
- ✓ An extended-cab truck is considered a passenger vehicle because of the extra seating and is, therefore, subject to the $30,000 limit. However, in the year of acquisition, where it is used more than 90 per cent of the time for the transportation of goods, equipment or passengers in the course of gaining or producing income, it may be considered a legitimate motor vehicle. The 90 per cent level

Tips and Traps continued

of use may be difficult to establish, and a detailed log of travel and description of goods, equipment or passengers is necessary.

✓ A GST registrant is entitled to a full GST input tax credit where the business use of the vehicle is greater than 90 per cent in the year of acquisition. Where business use is less than 90 per cent, the input tax credit will be pro-rated based on the percentage of business usage.

✓ Where the business use is less than 90 per cent, the individual will be deemed to have paid GST equal to 5/105 of the capital cost allowance claim on the vehicle. Therefore, the individual must claim back the GST over several years as the vehicle is depreciated for tax purposes.

✓ The recoverable GST is also limited for any vehicle caught under the rules that limit the capital cost allowance pool addition to $30,000. In those situations, the GST that can be claimed back is limited to the GST on the first $30,000 of cost.

For example:

An individual purchases an extended-cab truck for $33,600 (including GST), and the vehicle is used 50 per cent of the time for business:

GST Recoverable	
Year 1	
Maximum cost per Class 10 ($30,000 + GST)	$31,500
CCA rate (half year rule @ 15%	$4,725
Business portion@50%	$2,362
GST recoverable – Year 1 ($2,362 x 5/105)	$112
Year 2	
UCC ($31,500 - 4,725 - 112)	$26,663
CCA rate @ 30%	$7,999
Business portion @ 50%	$3,999
GST recoverable – Year 2 ($3,999 x 5/105)	$190

✓ The rules for GST on trade-ins generally require GST to be paid on only the difference between the price of a new vehicle and the trade-in value.

Machinery

Farm machinery is treated as a capital asset for income tax purposes. Machinery and equipment do not fall under the definition of “qualified farm property” for the purposes of the $750,000 capital gains exemption.

Tips and Traps

Capital Gains

✓ A disposition of machinery or equipment for proceeds greater than the original cost will result in a capital gain.

✓ The *Income Tax Act* does not include machinery and equipment as "qualifying farm property" for the purposes of the $750,000 capital gains election.

Leasing

✓ In acquiring new farm machinery, farmers have increasingly been trading in a piece of machinery they own on a new piece of equipment that will be leased rather than purchased. The treatment of this type of transaction must be carefully reviewed.

✓ It appears as if at least two major forms of leasing agreements are prevalent. The first is a "capital lease," while the other is an "operating lease." A capital lease is frequently referred to as a "disguised" purchase agreement because the buyout is often less than fair market value.

Capital Lease

If the lease is a capital one, then the leased equipment should be treated as purchased with financing and subject to normal capital cost allowance and interest deductions.

Operating Lease

If an operating lease is chosen, then the trade-in of the old equipment should be shown as a disposition. It should also reflect a credit to the appropriate capital cost allowance class and recognize any capital gain. The value of the trade-in is likely a partial payment of lease payments, which should be deductible.

Prepaid Lease Payments

Be aware that legislation restricts the deduction of expenses (other than for inventory) for cash basis taxpayers where the expenses paid in the current period relate to a taxation year two or more years after the year of payment. In light of this, the trade-in value of the equipment may be partially deductible currently and partially in subsequent years if the lease term extends beyond one year after the year of the trade-in.

For example:

Facts: Traded in a tractor with a value of $90,000 on December 1, 2010.

- Value of trade-in is credited to the first 36 monthly lease payments of a 60-month lease (i.e. farmer will not need to make lease payments until month 37 on the new tractor).
- Lease payments on the new tractor would be $2,500 per month.
- First lease payment commenced December 1, 2010 (paid by way of credit for trade-in).

While it is not yet clear how the Canada Revenue Agency will interpret this provision, the result would appear to be:

Disposition of old tractor should be recorded by way of credit to Class 10 for proceeds on trade-in (assuming original cost of old tractor exceeded trade-in proceeds, the credit to the pool would be $90,000).

Tax deduction for lease would be $32,500 for 2010 (December 2010 lease payment and 2011 lease payments paid by trade-in).

Tax deduction for 2011 would be nil.

Tax deductions for 2012, 2013, 2014 and 2015 would be as follows: $30,000 for 12-14 and $27,500 for 2015.

- An aggressive position would be to claim a tax deduction in 2010 for 24 months of lease payments (rather than 13 months as illustrated).

Tips and Traps

Transfer to a Child

✓ Under the special "farm rollover" provisions, depreciable assets - depreciated under the declining balance method - can be transferred at the undepreciated capital cost of the assets. Recapture and/or capital gains are deferred until such time as the property is sold by the child. See the conditions to be met to allow this rollover as outlined in this book on capital cost allowance.

✓ Part XVII assets (pre- 72 assets depreciated under the straight-line method) can only be transferred at fair market value. No recapture will result, but it is possible that there could be a capital gain. Once the child acquires the property, capital cost allowance must be taken on the declining balance method.

Tips and Traps continued

Transfer to Spouse

✓ Declining balance assets transferred to a spouse during or after the lifetime of the farmer will generally move to the spouse at undepreciated capital cost. Any recapture of capital cost allowance or capital gain will be postponed until the sale of assets by the spouse or death of the spouse.

✓ Straight-line assets transferred to a spouse during a farmer's lifetime or on death will generally pass at "adjusted cost base." No capital gain, if any, will arise until the sale of the assets or the death of the spouse.

✓ Under the *Income Tax Act*, a farmer can elect to transfer depreciable assets to a spouse at the fair market value of the property. This provision would be useful where the spouse was going to continue to use depreciable assets in the active farm business and the deemed sale at fair market value would not result in significant tax to the farmer. (Note: the transfer must occur either at cost or at fair market value but not in between).

Transfer on Death

✓ Immediately before death, the taxpayer is deemed to have disposed of all depreciable property for proceeds equal to fair market value. Recaptured capital cost allowance as well as a capital gains may arise unless conditions in the will specify for a transfer to a spouse or child as described above.

Transfer to a Corporation or Partnership

✓ Where a farmer wishes to incorporate a farm business or transfer business assets to a partnership, assets such as machinery may be transferred to a corporation or a partnership without incurring an immediate tax cost. An individual may transfer machinery to either a corporation or a partnership at any amount between cost and fair market value if the appropriate income tax election is filed.

✓ An election form must be filed with the Canada Revenue Agency to record the transaction for tax purposes.

✓ Electing at any amount above cost will result in income to the transferor.

✓ To avoid tax, it is often necessary to elect on machinery at an amount equal to the undepreciated cost of the machinery. In some instances, this means that only debt up to the underpreciated cost can be transferred. Attempts to have more debt on the equipment transfer would result in an automatic increase in the elected amount and resulting tax. It may therefore be necessary to also transfer other farm assets that have cost base to allow debt to be assumed by the company without negative tax consequences.

$750,000 Capital Gains Exemption

$750,000 enhanced exemption is available on the following properties:

- Qualified Farm Property
- Qualified Small Business Corporation shares

Remember that if taxpayers used the $100,000 exemption (available before 1995), they only have $650,000 of the enhanced exemption available. If they have not used the $100,000 exemption, then they have the full $750,000 enhanced exemption available.

Note that the material presented here is merely a summary of the rules, and the *Income Tax Act* should be consulted in all cases.

Summary of Rules

Qualified farm property includes the following:

- certain real property (see below)
- shares of a family farm corporation
- interest in a family farm partnership
- certain eligible capital property

Real property:

- land and buildings (not machinery and equipment) used in the course of carrying on farming business in Canada by:
  - Individual
  - if the individual is a personal trust, by a beneficiary of the trust
  - spouse, child or parent of the individual
  - family farm corporation/partnership of the individual, spouse, child or parent
- if property acquired before June 18, 1987, must be:
  - used in the year of disposal;
  - used in any five years during period when owned by individual, spouse, child, parent, or family farm partnership; or
  - meet the post June 17, 1987, rules.
- if property acquired after June 17, 1987:
  - preceding 24 months, property must have been owned by individual, spouse, child, parent, or partnership; and
  - gross revenue from farming exceeded income from all other sources for two years of ownership, or the property was used by a family farm corporation or family farm partnership throughout 24-month period, during which time the appropriate individual was actively engaged.

The definitions generally require a qualifying individual (or spouse, parent or child) to be actively engaged on a regular and continuous basis. Interpretation Bulletin 268R4 discusses this requirement and concludes it is a question of fact; however, when the person is "actively engaged" in the management and/or day-to-day activities, then the requirement is considered met (refer to Interpretation Bulletin 268R4).

Share of a Family Farm Corporation or Interest in a Family Farm Partnership

- substantially all (interpreted by the Canada Agency to mean more than 90 per cent) the property owned by the corporation/partnership was used by it (or other qualified users including individual, spouse, child, parent, family farm partnership, etc.) in a farming business in which one of the other qualified users was actively engaged.
- throughout previous 24 months, more than 50 per cent of assets must have been used in a qualifying farming business (i.e. active involvement of a qualified user).

- for the test on use of the property, in the case of the corporation, may include shares/indebtedness of other corporations that meet the use of property test.

Eligible Capital Property

- used by a qualified user in the business of farming with similar use tests as for real property (see previous page).

Crystallizing the $750,000 Capital Gains Exemption

Given the uncertainty of future changes in tax law, any owner of farmland might consider crystallizing their capital gain exemption to increase the cost base of the land for any future sale or deemed disposition on death now rather than waiting for an actual disposition to occur.

Several techniques can be used in a non-arm's length relationship to crystallize the gain without losing family control of the land including:

- Sale to Spouse
- Sale to Children
- Sale to a Corporation
- Sale to a Partnership
- Sale to a Trust

Sale to Spouse

A property (e.g. farmland) can be sold to a spouse for fair market value or gifted to the spouse.

An election under 73(1) must be made on the seller's tax return for the year of sale to elect to have the transfer to the spouse occur at fair market value so that a capital gain will result.

- no prescribed form exists for a 73(1) election

Normally, the transfer is structured as occurring for a non-interest bearing note payable, say, 30 days after demand. This approach is chosen since the spouse usually does not have resources to pay for the purchase or does not wish to do so. This offers an advantage over a gift in the use of a capital gains reserve to control alternative minimum tax (discussed later) and also leaves some control with the transferor spouse.

The impact of attribution rules must be considered. If the property is leased, any net rental income could attribute back to the former spouse. This would occur unless the purchasing spouse actually pays full fair market value at the time of sale or any remaining debt bears interest at commercial rates, and interest is paid in full each year (during the year or within 30 days after the end of the year). There is no attribution, however, if the recipient spouse uses the property to earn income from a business, even if the above conditions are not met.

Any capital gain on a future sale by the purchaser spouse will also attribute back to the vendor spouse unless the same conditions are met to avoid attribution of property income.

Sale to Children

A property (e.g. farmland) can be transferred to a child.

If the property is farm property that would rollover under 73(3.1) - for example, qualifying farmland or buildings - or 73(4.1) - shares of a family farm corporation or partnership - the sale must occur for actual proceeds (cash or debt consideration). If the property were simply gifted, a capital gain would not result as the property would automatically rollover at its cost base pursuant to those sections.

The amount of proceeds can be any value between cost and fair market value so that a gain less than the full gain on the property may be triggered.

The sale may be structured as a sale for a promissory note that a parent may require payments on. The balance of the note owing on a parent's death could be forgiven under the will without tax consequences. However, forgiveness of the indebtedness other than through a will can cause adverse tax consequences.

There is a need to consider the impact of attribution. If the property is leased, any net rental income could attribute back to the parent. This situation would occur unless the purchasing child actually pays fair market value at the time of sale or any remaining debt bears interest at commercial rates, and interest is paid in full each year (during the year or within 30 days after the end of the year).

Any capital gain on a future sale by the purchaser child will not attribute back to the vendor parent (but watch Subsection 69(11) of the *Income Tax Act* if the child owns less than three years).

Income attribution will not occur if the purchaser child uses the property in his or her business - even if the above conditions are not met. The attribution rules do not apply to business income.

By structuring the transfer as a sale at fair market value, with the child giving debt consideration such as a non-interest bearing note payable due, say, 30 days after demand, a capital gain reserve may be available to mitigate the effect of the alternative minimum tax (AMT) or a clawback of Old Age Security (OAS). The debt on the land gives the parent some control over the land in that a sale or pledging the land for security would require repayment of the debt or a preferred creditor's position.

Note that on a sale of farmland to a child, the reserve can be spread over a period of up to ten years (as opposed to the normal rule of five years).

Sale to a Corporation

In many cases, incorporation may make sense for a farmer, or the farmer may already have a corporation in place but still own land personally.

A transfer of qualifying property to a corporation will result in a sale at fair market value and will, therefore, trigger any capital gain that exists.

A Section 85 election is often used on the transfer of property to a corporation. This option allows the amount of gain triggered to be controlled by use of the appropriate elected amount on the election form. This can be particularly useful where the gain is in excess of $750,000 or there is some uncertainty over the fair market value of the property.

In addition, it allows buildings to be elected upon separately so that no recapture of depreciation is triggered - assuming the appropriate elected amount is used.

Triggering the exemption on land or quota, for example, can allow debt to be absorbed by the corporation so that it can be paid with higher after tax dollars.

If little or no debt exists, the triggering of the capital gain on incorporation can often result in a tax paid shareholder loan that can be drawn on in the future by the shareholder without further tax.

A reserve to avoid alternative minimum tax (AMT) or other tax consequences is not available on a transfer of assets to a controlled corporation. See section on Corporations for more information.

Sale to a Partnership

A very good option that can provide both income splitting and use of the capital gains exemption where a corporation is not warranted is through the use of a partnership.

For example, Mr. and Mrs. X could form a partnership to carry on the farming business. Farming assets could be transferred to the partnership and the appropriate capital gain triggered on any assets.

It is very important that the appropriate income tax election is filed - otherwise the transfer of the property to the partnership would occur at fair market value, and recaptured depreciation and other income could result on the transfer as well as capital gains.

Mr. and Mrs. X would then continue farming and splitting income according to the partnership agreement.

One concern with this arrangement might be what would happen on death. If the partnership agreement is properly structured, a beneficiary could have the following choices:

1. Receipt of property in settlement of a right to partnership property;
2. Undivided interest in each and every asset of the partnership; and
3. The beneficiary might simply become the new partner (replacing the deceased) if the partnership agreement provides for that event. See "Partnerships" for more information.

Sale to a Trust

It may also be possible to crystallize the capital gain exemption by transferring the qualifying farm asset to a trust. As transfers to most trusts are recognized as a disposition for tax purposes, the capital gains exemption could be used. However, caution should be exercised to ensure the trust is appropriate for the circumstances. The *Income Tax Act* does not permit a "rollover" to most trusts.

As a result, the full amount of the capital gain will be realized. The concern should be to ensure that the amount of capital gain exemption available to the transferring taxpayer is sufficient to offset the capital gain. In addition, the transfer could trigger recapture of depreciation on assets such as any buildings located on the subject farm land. Of course, the exemption is not available to offset this recapture.

Tips and Traps

✓ While the capital gain exemption may be available to fully offset the capital gain, remember that the capital gain is included in net income, and the exemption is deducted in calculating taxable income. Therefore, items that depend on net income such as benefits for children, provincial senior's benefits and the clawback of Old Age Security could be affected.

✓ Alternative Minimum Tax (AMT) can also result when triggering a capital gains exemption. To avoid this result, you may wish to plan the transaction so that a capital gains reserve is available to reduce the amount of capital gain reported in the year by ensuring there are deferred proceeds. For example, a note payable due 30 days after demand vs. note payable on demand. No reserve is available on a sale to a controlled corporation.

✓ Always consider the impact of the Goods and Services Tax on any proposed transaction. In the case of shares, there may not be a significant concern. However, for the transfer of other property, you may wish to ensure the purchaser is a registrant for GST purposes before proceeding with any crystallization.

✓ The General Anti-Avoidance Rule (GAAR) is always a concern in tax planning. Information Circular 88-2 provides that the crystallization of a capital gain exemption is an avoidance transaction since it is undertaken primarily to achieve a tax benefit. However, it is not a misuse of the Act, nor is it an abuse with regard to the Act as a whole. Therefore the Canada Revenue Agency would not seek to apply GAAR to normal transactions undertaken to crystallize the capital gain exemption.

✓ It is common for a company to issue more than one class of common shares. In many cases, the company's Articles of Incorporation may require the retained earnings to be allocated equally among those common shares. Any dividends are restricted on those shares to the extent of retained earnings applicable to the particular class of common shares.

✓ In a technical interpretation, the Canada Revenue Agency suggested these shares would not qualify for the enhanced capital gains exemption if dividends had not been paid on them in each and every year because they failed to meet the definition of prescribed shares.

Tips and Traps continued

Did a $100,000 capital gains election taint property for the purposes of the $750,000 capital gains election?

✓ If a taxpayer used the $100,000 capital gains election on their 1994 personal tax return on property that would have otherwise qualified for the $750,000 Capital Gain Exemption, the taxpayer should be aware that the election could affect his/her ability to claim the enhanced capital gains exemption in the future.

Use of the 1994 election resulted in a deemed sale and reacquisition of the property. Therefore, the farm property would have to meet the more stringent tests that apply for property acquired after June 17, 1987, to be eligible for the enhanced capital gains exemption in the future.

Some uncertainty also exists over whether a new 24-month "holding period" would also need to commence on February 22, 1994. Since the answer is not clear, one might try to meet the 24-month test after February 22, 1994, before attempting to trigger the $750,000 exemption.

✓ Can land be transferred to a company to crystallize the exemption followed by immediate transfer back out to the individual who owned the land originally?

A strategy followed by some taxpayers would be the sale of land to a company at fair market value for a note. The land would then be withdrawn by the individual from the company against the note payable. The hope would be that that land would now have a higher cost base as a result. It is very likely that the Canada Revenue Agency would find this type of transaction offensive and treat it as a sham or use the General Anti-Avoidance Rule to remove the benefit of the transactions. In either case, the result would be no use of the exemption and no increase in the cost base.

Note, however, situations do occur where there are bona-fide reasons for land to be sold to a company and then sold back to the original seller. The company should then report a gain if the land value increased while held by the company (with no offsetting exemption). The Canada Revenue Agency should not be able to attack this type of transaction with the General Anti-Avoidance Rule.

Life Estate and Remainder Interest

Life estate and remainder interest is a concept that involves splitting one property title into two separate titles. Normally, the parents retain a life interest and the child receives the remainder interest in the property.

On the eventual passing of the life interest holder, the life interest simply disappears and the child receives full title. The death of the life interest holder does not constitute a transfer of property, and as a result, this event would normally result in no taxes or probate fees.

The parents can have use of the property for their lifetime, with the assurance that the child will get the title upon their deaths. This strategy often meets the parents' objectives of ensuring a source of income and control during their lifetime while giving peace of mind to their children.

The children are assured that regardless of what changes might be made to their parents' wills, the children will end up owning the farmland. Following this strategy while the land is being farmed would avoid future concerns about qualifying for rollover to a child if the land was rented out in later years.

Tips and Traps

- ✓ The concept is a useful method of crystallizing the capital gains exemption. However, the transfer must be structured as a sale (otherwise a rollover will automatically result under Subsection 73 (3.1)).
- ✓ Normally, a GST input tax credit can be used on a real estate transfer to allow the purchaser to remit the GST and claim an input tax credit where the purchaser is using the property in a commercial activity. In the case of a remainder interest, the child cannot use the property in a commercial activity while a life interest exists, unless the child leases the property from the parent (which mitigates the GST issue).
- ✓ The Canada Revenue Agency does not have a clear policy on the treatment of GST on the transfer of a remainder interest. For now, the Canada Revenue Agency appears to allow a child to claim an offsetting input tax credit on form GST 34E. See sections on Land Transfers and GST.
- ✓ This method of ownership can result in difficulty in using the property as collateral for a loan without the consent of both life interest and remainder interest holders. This situation could be seen as an advantage as it alleviates the parent's concerns on future financing while both parties are still alive.
- ✓ The consent of both the life interest and remainder interest holders is necessary to avoid difficulty in selling the property during the lifetime of both parties. Again, this situation may be viewed as either an advantage or disadvantage, depending on the viewpoint.
- ✓ Should the parent subsequently decide to sell/transfer the life interest to the child before the parents' death, the interest could be sold or rolled over to the child under Subsection 73 (3.1) if the appropriate qualifications are met. The cost of the life interest (assuming Section 43.1 applied at the time of sale of the remainder interest) is the fair market value of the interest at the date of sale of the remainder interest. Therefore, a sale at a later date would usually result in proceeds less than cost (due to the ever decreasing life expectancy of the parent).

Land Transfers and GST

GST on purchases of commercial real property (by a GST registrant) are reported by the Purchaser on their GST returns for the period that includes the date of purchase. Assuming the property is going to be used in a commercial activity, an offsetting input tax credit is available. As a result there is no requirement to pay GST to the vendor on the purchase.

Quota

A farm quota is a right granted by the government that allows a producer to sell certain specified farm commodities. For tax purposes, quota is treated as an intangible asset. When a quota is purchased, three-quarters of the quota cost is added to the Cumulative Eligible Capital (CEC) account. Regardless of whether the farmer calculates tax on the cash or accrual basis, the purchase cost is the amount paid plus any other amount owing or outstanding because of the quota purchase.

At the end of the year, the balance of the CEC account is amortized on the declining balance basis at a maximum rate of seven per cent per year. In other words, seven per cent of the value of the CEC account is recorded as an expense similar to capital cost allowance. The balance in the CEC account is similar to the undepreciated capital cost of a depreciable asset.

When a farm sells quota the tax rules are quite complex. In general terms the sale of quota results in two income sources. The first is an income inclusion reflecting the amortization taken (if any) on the original purchases of quota. The second is an income inclusion which may be eligible for the capital gain exemption in the case of an individual or treated as business income in the case of a corporation.

Tips and Traps

✓ Transfer to a corporation - a farmer can roll a quota into a corporation and claim the enhanced capital gains exemption on the increase in value. However, the increase in value of the quota (the "bump") cannot be added to the CEC pool and depreciated. This "bump" will, however, reduce any gain on a future sale by the company, and often a tax-paid shareholder loan can be created on transferring the quota to a company (allowing the farmer to draw cash against this loan without further personal tax).

✓ Increases in value - if a farmer anticipates a future increase in the value of a quota, it would be beneficial to hold the quota personally rather than in a corporation. This would ensure that any gains on sale would qualify for the capital gains exemption provided the exemption still exists.

✓ Income from the sale of quota by a company (where the quota was used in an active business) will qualify for the small business deduction and normally be taxed at approximately 14 per cent.

✓ In many operations (especially poultry), it may be beneficial on a sale to ensure the allocation of proceeds separately between buildings and quota in the sale agreement. This allocation would ensure the appropriate portion is allocated to quota (which may be eligible for the exemption in the case of an individual) and would minimize recapture on buildings.

✓ Remember that personally owned quota does not rollover to a child on the death of a former.

Capital Gains Exemption - Qualified Farm Property and Quota

The definition of Qualified Farm Property includes an eligible capital property, providing the property was owned for a period of at least 24 months prior to the sale. A situation could arise where some quota was owned for more than 24 months and some was acquired within 24 months. In this instance, the Canada Revenue Agency has given comfort in some situations that the portion of the gain that qualifies for the exemption would be determined by pro-rating the gain over the total quota and claiming the exemption on the portion that had been held for 24 months.

Government Grants and Assistance

Government grants or subsidies will either be included in income in the year they are received or used to reduce the cost of assets purchased. Listed below are some of the common assistance programs.

Drought Deferral

Farmers farming in a region designated for the year as a "Drought Region" are eligible for special relief if they were forced to sell a significant portion of their breeding herd. The *Income Tax Act* allows the farmer to defer paying tax on the sale of the herd as a result of drought. The list of regions affected is designated each September by Agriculture Canada's Prairie Farm Rehabilitation Administration in Saskatoon.

To qualify for the special provision, a farmer in a designated region must have sold off (and not replaced) at least 15 per cent of the breeding herd. If the farmer meets the conditions, up to 90 per cent of the net sales of the breeding animals are not included in farm income until a later year, when the area is no longer designated as a drought region.

There is no specific requirement to replace the breeding herd in the year the deferred income must be reported or in any other year.

AgriStability

This program is designed to allow farmers to protect their farm operation against large declines in their farm margin. It directs government funds to those farmers who experience margin declines in excess of fifteen percent. Farmers must pay an annual fee to be part of this program. Income received from this program is considered business income for tax purposes.

AgriInvest

This program is designed to allow farmers to protect their farm operation against small declines in their farm margins. Participants are allowed to make deposits to their AgriInvest account based on a percentage of their allowable net sales and receive matching government funds. The funds can be withdrawn when the farmer wishes to. Contributions to the account are not tax deductible. Government matching funds and investment income earned in the account are not taxed until withdrawn from the account.

Other Government Programs

Other program payments are often made to deal with specific issues in the farm community. Taxation of those amounts depends on the nature of the payment.

Relocation of Farm Operation

A farmer looking to relocate a farming operation will likely dispose of the property currently used in the operation. Normally, a disposition of the land and buildings for proceeds in excess of the cost will result in a capital gain and recaptured capital cost allowance in the year of sale.

The *Income Tax Act* provides special provisions to defer tax where a voluntary disposition of a business property occurs. The tax rules allow a tax-deferred rollover of certain business assets if they are replaced by similar business assets before the end of the taxation year immediately following the year of disposal. To qualify for this rollover:

- The assets must be land or buildings used in a business immediately before the disposition;
- The replacement asset must be purchased before the end of the first taxation year following the year of the disposition of the original assets;
- A letter of election must be filed with the tax return for the year the replacement property is acquired;
- The replacement asset must be used in the same or similar business as the original asset; and
- If the owner was not a Canadian resident, the property must be taxable Canadian property.

Tips and Traps

✓ Farmland being crop shared would not qualify under these rules, nor would rented property (unless used by a related person in gaining or producing income from a business)

✓ Where a replacement property is not acquired until the following taxation year, any tax owing on recaptured capital cost allowance or capital gain must be paid in the year of sale. When the replacement property is purchased (within the time limits set out above) and the relevant election is made, the tax return for the year of sale will then be reassessed to determine the amount of the refund.

✓ It is possible to use the replacement property rules on replacement property purchased prior to the disposition of the former business property. The replacement property election must be filed in the year the replacement property is purchased; there is no time restriction for selling the property to be replaced.

✓ The Canada Revenue Agency at one time had taken the position that these rules were not available in situations where farm size increased but no longer appear to take that position.

Setting Up a New Farm Site

A farmer just getting into the business of farming or relocating a farm site may be faced with many decisions in setting up a new farm site. Various expenses are incurred to get the operation up and running. These start-up costs are often treated differently for tax purposes.

Replacement Property

In a situation where a farmer has disposed of a farm and is setting up a new farm site, the disposition could have resulted in capital gains or recaptured capital cost allowance.

The *Income Tax Act* provides special provisions to defer tax where a voluntary disposition of a business property occurs. The tax rules allow a tax deferred rollover of certain business assets if they are replaced by similar business assets before the end of the taxation year immediately following the year of disposal. See the previous section on Relocation of Farming Operations.

Tips and Traps

✓ The Canada Revenue Agency at one point had taken the position that these rules were not available in situations where farm size increased but more recently they have not taken that position.

✓ Property purchased prior to the sale of the former business property will qualify as replacement property. No two-year restriction applies but the purchase must, in fact, be a replacement property.

Utility Connection

The *Income Tax Act* provides for the deduction of amounts paid by a taxpayer for making a service connection to his place of business when computing income from that business. Certain conditions must be met so that a deduction may be claimed under this provision:

1. The service connection must be for the supply of electricity, gas, telephone service, water or sewers supplied by the payee;
2. The supply must be by means of wires, pipes or conduits;
3. The service connection must be to the taxpayer's place of business and not solely to a residence;
4. The deduction can only be claimed if the amount is paid to a person who deals at arm's length with the taxpayer; and
5. Such an amount will not be deductible in a taxation year unless it is paid in that year, regardless of when liability for the amount was incurred.

Tips and Traps

✓ Payments made for service connections for the development of the property for sale are not deductible.

✓ The deduction only applies if a taxpayer does not own or will not own the property (i.e. wires, pipes, conduits) used in making the service connection. Title to the connection property sometimes vests in the taxpayer if it is within the boundaries of his property. If this is the case, a deduction is not permitted but will normally qualify for capital cost allowance.

✓ Sometimes, the cost of a service connection does not qualify for a current year deduction or as an addition to capital property or inventory. Where this happens, the cost will qualify as an eligible capital expenditure if it is an outlay or expense made or incurred for the purpose of gaining or producing income from a business.

Road Construction

Construction costs for a paved road to a new farm site are a capital cost added to Class 17. To be able to make a road, it may be necessary to clear or level the surface of the land on which that depreciable property is to be built. The cost of clearing or leveling will ordinarily be accepted as part of the depreciable cost of the property built on the land, rather than as part of the cost of the land itself.

The costs of an unpaved road are generally deductible expenses in the year they are incurred.

Farmers Clearing and Leveling Land or Laying Tile Drainage

Taxpayers (owner or tenant) may pay amounts for clearing or leveling land or laying tile drainage for the purpose of carrying on the business of farming. Clearing or leveling land for this purpose includes brushing and breaking land, (ie: clearing the land of brush, trees, roots, stones etc. and the initial ploughing) so the land can be put into productive use.

You are not required to deduct all the costs of such improvements in the year they are incurred and paid. You may deduct any part and carry-forward the remaining unclaimed part to any other year at your discretion.

Purchase of Assets

New buildings and equipment purchased for the new farm site are capital assets that will be added to Capital Cost Allowance (CCA) classes. In the year a depreciable asset is acquired, the CCA that can be claimed on the asset is limited to one-half the regular CCA.

Rollovers

A rollover occurs when eligible property is transferred between two non-arm's length parties, and the recognition of a capital gain or loss or recaptured depreciation is deferred for tax purposes. Transferring farm property can be very complicated, so this is an area that must be approached very carefully.

Whenever taxpayers dispose of anything to a non-arm's length person for proceeds less than fair market value, they will be deemed to have received fair market value unless the transfer qualifies under one of the special rollover provisions.

In all cases where property is transferred to a related party, the income and capital gain attribution rules should be reviewed. In some cases, even after an asset has been transferred to a related party, income and, in certain cases, capital gains earned with respect to the transferred property will attribute and be taxed in the hands of the transferor.

Farm Property Transferred to Children

One of the important rollover provisions for farmers is the rollover provisions allowed under Subsection 73(3.1) of certain farm property to a child. To take advantage of this rollover, certain conditions must be met.

The conditions for a Subsection 73(3.1) rollover stipulate that the property must be a qualifying property (depreciable property, land or eligible capital property but not inventory) that was:

before the transfer, [the property was] used principally in the business of farming in which the taxpayer, the taxpayer's spouse, the taxpayer's parent or any of the taxpayer's children was actively engaged on a regular and continuous basis.

Tips and Traps

✓ The Department of Finance used the example that if real property had been farmed actively by the parent for 15 years, rented on a crop-share basis for 2 years and then transferred to the child who would actively farm the real property, they would permit a rollover of the farm property.

✓ However, if parent had farmed the property for 10 years, had rented the property out for 20 years and then transferred the property to the child who would actively farm the property, the rollover treatment would not be available. Unfortunately, Interpretation Bulletin 268R4, does not allude to this issue or provide any further guidance.

Percentage of Time

The bulletin does, however, go on to add a comment in Paragraph 24:

> There is no requirement that the property be used immediately before the transfer in the business of farming. However, if the property is used for some other purpose other than farming for some time, a question may arise as to whether the property was used primarily for that other purpose rather than in the business of farming.

This comment is consistent with the view of the Department of Finance when the wording was changed from “immediately before” to “before.” The example used in the explanatory notes referred to a situation of farm land used for 15 years in the business of farming and then rented for 2 years. This land would qualify for rollover while the land farmed for 10 years and rented for 20 years would not qualify.

The ability to take inactive farm land that has been held for several years and farm it actively for one or two years to meet the rollover rules appears to have disappeared.

The Subsection 73(3.1) rollover is not available for farm inventories.

Tips and Traps

✓ The Subsection 73 (3.1) rollover is automatic; no forms need to be filed. However, situations may exist where the taxpayer does not want the rollover to apply (e.g. available loss carry-forwards or wants to use the capital gains exemption). Since no election is available to avoid the rollover, the structure of these transactions must be carefully reviewed.

This approach would normally involve structuring a sale for actual proceeds equal to the desired value (between adjusted cost base and fair market value) to use loss carry-forwards or the capital gains exemption.

Farm Property Transferred to a Spouse

✓ Transfers of any type of capital property can occur to a Canadian resident spouse on a rollover basis according to Subsection 73 (1). This rollover is not limited to qualifying farm property. This rollover also happens automatically, and no forms need to be filed. An election is available to negate the rollover and have the transfer occur at fair market value (perhaps to use loss carry-forwards or the capital gains exemption).

✓ Taxpayers may wish to avoid the rollover on a transfer to a spouse. If so, they should attach a signed statement to their tax return electing not to have the provisions of Subsection 73 (1) apply to the particular transfer and report the transfer at fair market value for the year of the asset transfers.

Tips and Traps continued

✓ **In the case of a transfer to a spouse, the transfer can only occur at cost or fair market value and not at any value in between. These conditions are significantly different from the rules discussed previously for transfers of farm property to children.**

Partnerships

A partnership structure is common in farming businesses. A partnership is not defined in the *Income Tax Act*, but generally speaking, a partnership is the relationship between persons carrying on business in common with a view to profit. Co-ownership of property does not itself create a partnership.

To date, the Canada Revenue Agency has been extremely liberal in the determination of what does or does not constitute a partnership for income tax purposes. The legal question of whether a partnership exists can be very important not only for tax purposes, but because of the risk of joint and several liability that accompanies a partnership. The following factors have generally been considered to indicate a partnership:

- An agreement to share profits of a business
- Ability of each partner to contractually bind the other partners as well as the firm
- Use of the words "partner" or "partnership" in written documentation
- Some provision for continuing duration of the relationship between the parties
- Use of a firm name, joint bank account, joint accounting, etc.
- Formal registration, if any, as a partnership

Instant Partnerships

In some situations, taxpayers (usually spouses) have decided to split income by changing to a partnership from a proprietorship - with perhaps income splitting by payment of wages or management fees to the non-farming spouse. This change is often made without election forms or other tax planning. A partnership statement often deducts interest on funds borrowed for land and property taxes and shows the tax depreciation pools as a partnership calculation.

Significant concerns exist with this change to a partnership. Since interest, property taxes and depreciation are calculated and adjusted at the partnership level, the indication is that the assets (land, buildings and equipment) have been transferred to the partnership. The Canada Revenue Agency may be of the view that this is a disposition at fair market value of the assets, and the resulting capital gains, income and recaptured depreciation should be reported (and tax paid). This outcome can be avoided by proper planning and filing of the appropriate election forms.

Allocation of Partnership Income

The allocation of income is ordinarily established in the partnership agreement. In some cases this will be fairly straightforward (e.g. equal share), but in other instances, the allocation might be more complex.

Consider, for example, the situation where one of two partners will be providing all the effort, and the other partner will not be active in the partnership business on a day-to-day basis. The partners may agree that the active partner should receive extra income and therefore allocate the first $20,000 of income to the active partner. They then share all remaining profits equally. This extra allocation is often referred to as a wage, but in fact, partnerships cannot deduct wages to partners; therefore, it is simply an allocation of income.

Tips and Traps

- ✓ The *Income Tax Act* provides the Canada Revenue Agency with the discretion to challenge allocations if they seem unreasonable.
- ✓ Consider a situation where members of a partnership agree to share any income or loss from any source. If the principal reason for the agreement may reasonably be considered to be a reduction or postponement of tax, then the share of each partner is deemed to be that amount which is reasonable in the circumstances .
- ✓ Another situation that may be a problem concerns two or more members of the partnership, who are not dealing at arm's length, and the share of the income or loss is not reasonable having regard to capital invested, work performed, or any other relevant factor. Then, notwithstanding the agreement, their share will be deemed to be an amount that is reasonable in the circumstances.
- ✓ A farmer may want to consider the flexibility of income allocation between an active and inactive partner. An allocation could be paid to the active partners prior to the final partnership allocation amongst all partners.

Computation of Partnership Income

A partnership is not a person for tax purposes, but Section 96 of the *Income Tax Act* does provide that the income of a partnership should be computed as if the partnership were a separate person resident in Canada. The partners must recognize their share of partnership income in the year in which the partnership's taxation year ends. Each partner is taxed on his or her share of the partnership income for each year and on any capital gain realized upon the disposition of his or her partnership interest.

Tips and Traps

- ✓ Taxation year of the partnership is its fiscal period.
- ✓ Capital cost allowance is claimed at the partnership level on partnership assets. Assets held outside the partnership can be depreciated at the owner's discretion, but there is a question as to whether they must be leased to the partnership to trigger capital cost allowance.
- ✓ Reserves and elective amounts are also claimed at the partnership level (e.g. doubtful debts, mandatory inventory adjustments and optional inventory adjustments).
- ✓ Charitable and political donations must be added back to partnership income, and each partner claims a tax credit for their proportionate share.
- ✓ Salaries paid to partners do not constitute a business expense but are a method of distributing income.
- ✓ Rent paid to a partner is an expense to the partnership and income to the partner. (Don't forget that such transactions may be subject to GST.).
- ✓ Interest paid to a partner is normally considered to be a distribution of income and not an expense. However, a partnership can enter into a true lender-borrower relationship with interest as an expense, but interested parties should seek legal advice on how this is best evidenced.
- ✓ A partner may deduct expenses incurred personally in earning partnership income.
- ✓ A partnership of companies must consider specified partnership income (SPI) and the small business deduction (SBD) calculation. This restricts the use of a partnership to multiply the SBD by limiting the use of the SBD to the particular partner's percentage share of the partnership.

Tips and Traps continued

For example:

✓ Corporation A is a 50 per cent partner in a partnership carrying on active business. The partnership has net income for the year of $600,000 of which Corporation A is entitled to 50 per cent ($300,000). Assuming no other operations in Corp. A, the SBD is limited to $250,000 of net income (i.e. 50 per cent of $500,000 SBD overall limit).

Transfer of Property to a Partnership

When a taxpayer transfers property to a partnership and becomes a partner, normally the property is deemed to be disposed of for fair market value (per Subsection 97(1)). Where the partnership is a "Canadian partnership," the property may be transferred at a value other than fair market value (with the appropriate election).

A "Canadian partnership" is defined as a partnership in which all the members are resident in Canada at the time at which the term is being considered. When an election is made according to 97(2), a taxpayer may transfer property to a partnership on a tax-free rollover basis by choosing an elected amount equal to the cost amount of the property being transferred (and therefore defer the inherent gain). The elected amount will form proceeds for the transferor and also the cost to the acquiring Canadian partnership.

Tips and Traps

Subsection 97(2) Election

✓ If the transferor receives any consideration other than the partnership interest, the elected amount may not be less than the value of that other consideration.

✓ If depreciable property is transferred, the partnership will be deemed to have the partner's historical cost (i.e. for recapture purposes).

✓ Paragraph 13 (7) (e) limits the cost of a depreciable acquired from a non-arm's length person to the cost of transferor plus one-half of the excess of the transferor's proceeds over historical capital cost.

✓ In situations where the transferor has sheltered a capital gain with the capital gain exemption, Paragraph 13 (7) (e) (i) further reduces the depreciable amount where the property was acquired from a non-arm's length person by another amount. Similar rules exist for eligible capital property.

✓ Roll-in rules that apply on a rollover to a corporation under Section 85 are equally applicable to 97 (2).

✓ Regulation 1102(14) provides that depreciable property acquired from a non-arm's length person will remain property of the same class it was when owned by the transferor.

✓ There is no requirement to receive an interest in the partnership in consideration of the transfer as long as the transferor is a partner immediately after the transfer.

✓ Property eligible for a 97 (2) election includes any capital property, Canadian resource property, eligible capital property or an inventory (note that unlike Section 85, there is no prohibition with respect to real property inventory).

Tips and Traps continued

✓ Subsection 40 (3.4) contains special rules to prevent a majority partner from realizing a capital loss on a transfer of property to a partnership.

Is it possible to use a partnership to dispose of an asset to an arm's length party and defer all gains?

Example:
A taxpayer owns property that would result in taxable gains on a straight sale. The taxpayer and the purchaser form a partnership, and the taxpayer transfers the property to the partnership using Subsection 97(2) to defer the recognition of the gain. The purchaser contributes cash to the partnership, which the taxpayer withdraws, and because of the withdrawal, the taxpayer's share of the income and loss of the partnership is reduced. The partnership continues to carry on business.

The Canada Revenue Agency has dealt with this possibility directly in Information Circular 88-2 and threatens to apply the General Anti-Avoidance Rule (GAAR). The rule considers the use of the partnership to be an attempt to circumvent the provisions that dispositions of property are to be accounted for at the time of receipt, and the action would be contrary to the scheme of the *Income Tax Act* read as a whole. Therefore, 245(2) would apply to deny the tax benefits sought, and tax would be payable immediately.

Real Property Transfer to Partnerships

Unlike Section 85, Subsection 97(2) contains no prohibitions on the transfer of real property inventory into a partnership. This option could be used to indirectly incorporate real property inventory by first using a rollover to a partnership and then incorporating the partnership interest by transferring the interest to a corporation under Section 85. The Canada Revenue Agency has confirmed that the partnership interest itself would not be deemed to be real property.

Tips and Traps

✓ Watch out for the General Anti-Avoidance Rule if this method is chosen to circumvent the prohibition in Section 85

✓ When dealing with farmland (where it is a capital asset), you may not wish to use Subsection 97 (2) but rather have a sale occur at fair market value to trigger a capital gain that would be eligible for the capital gains exemption. In some cases, a Subsection 97 (2) election is still desirable to control the amount of capital gain to be triggered.

✓ This approach is applicable where the potential gain exceeds the available capital gains exemption or where a lower capital gain is desired to minimize the alternative minimum tax. Similar to an election under Section 85, an elected amount can be chosen on the election to trigger the appropriate amount of the gain.

✓ Even if you intend to trigger the entire capital gain on land, it may still be wise to file a Subsection 97 (2) election if there is some concern that the value of the land could be higher than estimated fair market value. This election would provide some protection against a reassessment that might otherwise increase the reported capital gain.

Incorporation of a Partnership

Two different methods exist to incorporate:

A. Incorporation of the assets of the partnership followed by wind-up of the partnership

B. Incorporation of the interests in the partnership followed by wind-up of the partnership into the company

A. Incorporation of partnership assets

Partnership property may be transferred to a corporation in exchange for shares using Subsections 85(2) and 85 (3). Once the transfer of partnership assets to the corporation in exchange for its shares is complete, the partnership must be wound up within 60 days of that exchange so that the partners receive those shares of the corporation held by the partnership. In this manner, the object of dissolving the partnership and transferring the business to a corporation can be accomplished without the realization of taxable gains or losses.

Tips and Traps

✓ If a business is expected to have start-up losses or if the business has quick write-offs available, consider beginning the business in a partnership form. This approach would allow early losses or write-offs to flow through to the owners who would then eventually incorporate the partnership property (consider non-tax items such as liability concerns).

✓ Note that the receiving company must be a Canadian corporation for rollovers to occur, and The Canada Revenue Agency requires that the transfers must occur to only one corporation (otherwise a partnership "butterfly" or splitting up of the partnership could occur). This result would be offensive to The Canada Revenue Agency since it would allow a tax-free division of partnership assets. Such a division is not provided for in the *Income Tax Act.*

✓ The first step is the transfer of assets by the partnership to the corporation in accordance with a Subsection 85 (2) election. Note that all members of the partnership must jointly elect and file form T2058 (although Powers of Attorney are used in widely-held partnerships)

✓ As consideration for the transfer of assets to the corporation, the partnership must receive at least one share of the capital stock of the corporation. However in practice, the number issued is determined by the need for shares in dissolving the partnership. For administrative ease, the shares are sometimes issued in the name of the partners rather than the partnership, and The Canada Revenue Agency's view is that this procedure does not invalidate the application of Subsection 85 (2) or 85 (3) .

✓ For Subsection 85 (3) to allow a tax-free distribution of the partnership, the only assets the partnership can hold are money or property received from the corporation as consideration for the disposition.

✓ If triggering a capital gain on the transfer of any depreciable assets by the partnership to a non-arm's length corporation, be aware of Paragraph 13 (7)(e). This stipulation will limit the depreciable cost to the corporation to the historical capital cost plus one half of the capital gain less twice the amount of any capital gain exemption deducted.

✓ Subsection 40 (3.6) does not allow a partnership to claim a loss on the disposition of eligible capital property or capital property to a corporation if the partnership controls the corporation immediately after the disposition.

✓ Consequences of the partnership wind-up - assuming conditions met so that 85 (3) applies:

- non-share consideration distributed to partners will have a cost amount equal to its fair market value

Tips and Traps continued

- this non-share consideration will reduce the partner's adjusted cost base (ACB) of the partnership interest (for allocation to shares received)
- adjusted cost base of shares distributed will be limited to the amount of any ACB the partner still has remaining in his or her partnership interest (with cost first being allocated to preferred shares up to their fair market value and any residue to common shares)
- the partnership will be deemed to have disposed of its property immediately before the dissolution at the tax-carrying value of the property

✓ Subsection 85 (2) and 85 (3) transfers may not always be tax-free: a partner may realize a capital gain where the fair market value of the non-share consideration received is more than the adjusted cost base of the partnership interest.

B. Incorporation of partnership interests

A partnership interest can be transferred to a corporation in accordance with an 85(1) election. Assuming all interests are transferred to the corporation, then 98(5) may apply to allow a tax-free wind-up of the partnership. A “bump” of the cost base of certain assets may be available if the cost base of the partnership interests is greater than the partnership’s net assets.

Tips and Traps

✓ On the transfer of the partnership interests, consider electing high enough to trigger a capital gain exemption if the partnership qualifies for the purposes of the capital gains exemption (and assuming the exemption is available to the vendor partner).

✓ This method of incorporating a partnership can result in a capital gain on the dissolution of the partnership if the cost base of the partnership interests to the company is less than the cost amount of partnership properties.

✓ A partnership interest can be transferred to a corporation in accordance with a Subsection 85 (1) election. This election can be used to limit the amount of the capital gain that would otherwise result by electing at the appropriate amount. Note, however, that if the adjusted cost base of the interest is negative, a capital gain will result since the minimum elected amount is $1. If the partnership qualifies for the enhanced capital gains exemption, the fact that the capital gain results from a negative cost base does not preclude claiming the exemption.

✓ If all partnership interests are transferred to one corporation, the partnership will cease to exist, and Subsection 98(5) may apply to the partnership.

✓ Subsection 98(5) applies where a Canadian partnership ceases to exist, and within three months, a partner carries on what used to be the partnership's business and continues to use some of the property that was partnership property received as proceeds of disposition of his or her partnership interest.

✓ Subsection 98 (5) provides:

- partnership deemed to dispose of its assets at cost amount rather than fair market value (other than property transferred prior to acquisition of former partners' partnership interest by the proprietor)
- proprietor deemed to dispose of partnership interest for the greater of:

  a. adjusted cost base of interest together with cost of all interest purchased from other partners

  b. cost amount of all partnership properties

Tips and Traps continued

Therefore it is possible that a capital gain could result on the dissolution of the partnership.

✓ On the rollover during the lifetime of a partner in a farm partnership, a negative cost base will result in an immediate capital gain on the transfer to a child or spouse to the extent of the negative amount (even though the partnership would otherwise qualify for rollover).

✓ A "bump" is available under 98(5) for non-depreciable capital property to the extent that the partner/proprietor's adjusted cost base in the partnership is greater than the net assets of the partnership. In very limited circumstances, a "bump" may be available for depreciable properties as well (where partnership existed before December 4, 1985).

✓ Rules in 98 (5) are not elective, but rather apply automatically.

Land Registration

✓ Land cannot be registered in partnership name;

✓ Often simply registered in the partners' names;

✓ May consider registering a caveat against the title to protect the partnership ownership;

✓ May use a bare trustee corporation to hold the land for the partnership.

Partnership Rollover and Mandatory Inventory Rules

✓ Subsection 85 (1) (c.2) applies to rollovers to corporations and partnerships. The section provides that the minimum elected amount for the rollover provisions relating to cash basis farm inventory is restricted to that amount which would have been included in income under Mandatory Inventory Adjustment rules (28(1) (c).

✓ Prevents the creation of a farm loss by rolling over purchased inventory before the year end of the taxpayer or partnership. See paragraphs 12 and 13 of Interpretation Bulletin 427R.

Problem with Debt in Excess of Cost of Assets on Rollover to a Partnership

✓ An individual may wish to rollover a cattle herd to a partnership but has debt of more than the cost of the cattle that he or she wishes the partnership to assume.

✓ If the rollover is done under such circumstances, the transfer value elected must at least be equal to the debt assumed and income would result.

✓ If the debt creates an income problem, a strategy is to roll the inventory for $1. Subsequently, the partnership borrows an amount from the bank and pays it out as a capital distribution (creating a negative cost base). The Canada Revenue Agency may use the General Anti-Avoidance Rule to attack, especially if transactions occur in quick succession, and require the individual to be taxed on proceeds received on the inventory.

Using a Partnership to Access the Capital Gains Exemption on Farm Assets

✓ Farmer A and his child wish to use the capital gains exemption in the course of incorporating their farming business.

✓ Unfortunately, the majority of value of their farming assets rests in their cattle herd which has no tax basis - only nominal capital gains exist on their land .

✓ Farmer A and his child propose to transfer their respective farm assets to a partnership on a rollover basis. Subsequently, they will transfer their partnership interests into a corporation and create a capital gain on which to claim their capital gains exemption.

Tips and Traps continued

What Will the Canada Revenue Agency Think of This Approach?

If the transfers to the partnership and, subsequently, of the partnership interest to a corporation occur within a short time, the Canada Revenue Agency could argue the partnership interests are held because of income rather than capital account. Therefore income rather than a capital gain would result. Alternatively, The Canada Revenue Agency may seek to use General Anti-Avoidance Rule to re-characterize the transactions as merely a transfer of assets to a corporation (therefore not crystallizing the same amount of capital gain).

Note that 54.2 of the *Income Tax Act* provides that where a proprietor rolls assets into a corporation and then sells the shares of the corporation shortly after, the shares are deemed to be capital property. But this provision does not appear to extend to the situation described above.

It is necessary for the farm partnership to be in existence for 24 months to qualify for the enhanced capital gains exemption available for qualified farm property. The Canada Revenue Agency has indicated this condition in a private interpretation.

Commodity Trading

Commodity trading has become very common in the farming industry. There are various terms that an advisor should be familiar with.

"Put" vs. "Call"

A "put" gives the holder the right to sell an asset at a specified price and within a specified time. A "call" gives the holder the right to buy an asset at a specified price and within a specified time.

"Hedger" vs. "Speculator"

A "hedger" is a person who deals in the actual commodity they are purchasing puts and/or calls for and is generally purchasing a futures contract (put or call) to protect their holdings. A "speculator" is a person who does not deal in the physical commodities and purchase futures contracts to try to take advantage of price fluctuations and make profits.

How do We Deal with Payments for Puts and Calls (Futures Contracts)?

Normally, the person must make a payment into a broker's account to provide a margin for the puts or calls purchased. These payments are not tax deductible when made.

Futures contracts are usually closed out before the actual delivery date of the physical commodity. Less than two per cent of futures contracts actually result in physical delivery of the commodity. Normally, a profit or loss will result when a contract is closed out, at which point a deductible expense, capital loss, income or capital gain could result. Generally, no income or loss is recognized on a futures contract until it has been closed out.

Is the Gain or Loss on Income or Capital Account?

Interpretation Bulletin 346 outlines the Canada Revenue Agency's position on this topic. Generally, if the person is hedging the commodity they deal in (e.g. a feedlot hedging in the cattle market), then the gain or loss is considered on income. Where the person was merely a speculator, the Bulletin allows the gain or loss to be treated on income or capital account. However, once a method is chosen, the treatment must be consistent from that point onward.

Consider a situation where a person trades in the futures market to an extent greater than that required to hedge production. Then, the tax treatment could be seen as income for the hedging portion and on capital account with respect to the speculation part of the transaction.

Forgiveness of Debt

The debt forgiveness rules are more complex and include a specific ordering that the forgiven amount must be applied against (tax items such as loss carryforwards is outlined in the *Income Tax Act*.)

Subject to some relieving provisions, the rules also require that some or all of the forgiven amount left over after reducing tax pools and balances be included in the debtor's taxable income. A complete analysis of these new rules is beyond the scope of this publication, and a detailed analysis would be required for each client's situation.

Prepaid Expenses

Farmers on a cash basis commonly pre-pay expenses for the next farm year to reduce their current-year farm income. There are some restrictions of a current-year deduction of prepaid expenses in the *Income Tax Act*.

The Act provides the following. Payments, other than for inventory, that reduce the cash-basis income of a farming business for a year do not include prepaid expenses relating to a taxation year for the business two or more taxation years after the year of payment.

The change also allows a deduction for such a payment paid in a preceding year. This is limited where the payment was not deductible in another taxation year but would relate to the year in question if it were not for the use of the cash method (i.e. get deduction when the payment is no longer a prepaid expense).

Tips and Traps

✓ The legislation catches situations such as last-month payments and down payments on leases. See the example under the Machinery section.

✓ Another example of this change would limit prepaid interest expenses in the same way.

Prepaid Feed

In a technical interpretation regarding the purchase of feed prior to year-end to get a tax deduction, two situations were considered:

1. Prior to year-end, a farmer paid for feed that was delivered in the subsequent year; and
2. Prior to year-end, a farmer paid a feed supplier with the amount to be credited against feed purchases made in a subsequent tax year.

The Canada Revenue Agency felt that in situation (1), the payment would be deductible if legal title to the feed passed to the farmer at the time of payment, but in situation (2), no deduction would be allowed since no goods have been acquired.

Farm Business Income vs. Rental Income

A farmer may arrange farming operations in several different ways. The farmer may enter into a custom-work arrangement where he hires an operator who performs farm work in exchange for a flat custom-work fee. The farmer may also operate on a cash rent or crop-share basis. In this situation, the farmer effectively rents the land to another party. The rent is then paid either at a set cash price-per-acre or as a share of the crop harvested by the person carrying on the farming activities (this is often net of some of the expenses).

Each of these arrangements may have different income tax implications.

Farmers who rent out their farms on either a cash or crop-share basis may be seen as not carrying on the business of farming. If this is the case, the farmer may be required to file on an accrual basis for this rental income. In addition, there may be problems if the farmer or certain related parties are not using the property in the farming business themselves, but are rather renting the properties out under either of these alternatives. These situations may jeopardize the farmer's ability to roll the property over to a child during lifetime or on death. (See section on Rollovers)

If, however, a custom operator is hired to carry out many of the farming activities, but the farmer maintains all key cropping decisions and risks, then it is likely the farmer would still be considered to be carrying on the business of farming. This arrangement would avoid some of the concerns outlined in the previous paragraph.

In many situations, it may be appropriate to enter into a "joint venture" where both parties incur expenses, are involved in management decisions and are subject to risk. With this approach, both parties to the agreement should be considered in the business of farming.

Corporations

A corporation (or company) is another form of business organization a farm can use. A corporation is considered a separate legal "person" for income tax purposes.

Where a farmer decides to use this form of carrying on business, tax deferred rollovers and appropriate elections for income tax and the goods and services tax are often necessary to avoid immediate tax on transferring assets to the company. The individual farmer who decides to incorporate will then often become an employee of the corporation.

Advantages of a Corporation

Tax rate

A corporation differs from the sole proprietor and partnership forms of business in that corporations do not pay tax on their earnings at progressive tax rates. The current tax rate in Alberta for active business income is approximately 14 per cent on the first $500,000 of taxable income each year.

The tax rate on active business income above $500,000 per year is approximately 26.5 per cent.

Investment income such as interest, rent and capital gains are taxed at a rate of approximately 45 per cent.

Limited liability

A corporation offers limited liability such that legal action taken by creditors can only be against the assets owned by the corporation. For the farmer with assets outside the company, this restriction offers protection.

However, where the farmer has given a personal guarantee on a loan to the corporation, the advantage of limited liability is greatly reduced. In addition, directors of corporations can be held personally liable for certain company debts - for example, payroll remittances.

Income splitting

The corporation may pay both spouses a salary for services rendered. In addition, dividends may be paid to shareholders even though they may not be active in the operation. This way, income splitting can result with the advantages of using low marginal tax brackets and available personal exemptions. See section on Income Splitting.

Continuity

A corporation can live forever, and therefore in an estate situation, the individual who has passed away may have simplified his or her affairs.

Disadvantages of a Corporation

Additional costs

Starting a company means incurring both legal and accounting fees as well as ongoing annual fees to maintain the company.

Additional administration

With a corporation, more formal documentation such as a complete set of financial statements including a balance sheet is required.

Certain tax disadvantages

- lack of principal residence exemption for houses owned by the company;
- taxable benefits for any personal use of company assets such as cars or houses;
- corporate losses cannot be transferred and used personally;
- assets transferred into a company can be transferred tax-free (with proper elections) but cannot be removed from the company without triggering a potential tax liability;
- companies are not eligible for the $750,000 capital gains exemption on the sale of any farm assets. Shareholders may be eligible for the exemption on the shares of the company if qualified, but this exception does not assist the company on a sale of a company asset.
- without proper planning on death, two levels of tax could result - once on the deemed disposition of the shares of the company if it does not meet any special rollover rules and secondly, on extracting funds from the corporation.

Company-owned Houses

Individuals who live in a company-owned house will also be subject to a taxable benefit. The amount of this benefit is not always clear. Often, the benefit is equal to what an arm's-length person would have paid for the use of the house. However in some cases, The Canada Revenue Agency has taken the view that the taxable benefit should be based on the greater of the fair market value or cost of the house times an interest factor. This approach can lead to a very significant taxable benefit.

Loans

Low-interest or interest-free loans from a corporation to an employee also result in a taxable benefit based on the prescribed rate set quarterly by the Canada Revenue Agency.

Where the individual receiving the loan is a shareholder (or connected thereto), the entire amount of the loan may be included in personal income. In effect, this is double taxation since the company receives no deduction for this loan. To avoid this problem, the loan must be repaid within one year of the end of the corporation's taxation year in which the loan was made. In addition, the repayment cannot be a part of a series of loans and repayments. If not repaid, the income inclusion is for the taxation year in which the individual received the loan.

Certain loans to shareholders may be exempt from this income inclusion if they are:

- qualifying loans made in the ordinary course of the lender's business;
- a qualifying loan to purchase a home;
- a loan to purchase shares in the employer (company);
- or a loan to purchase a car to be used in employment.

Even if the loan is for one of these qualifying purposes, certain additional conditions must be met. These conditions include bona fide repayment terms, and the reason for the loan should be because of the shareholder's employment versus shareholding.

Loans to shareholders included in the shareholders' income are not subject to the deemed interest benefit; however, all other loans are subject to an interest benefit.

Note that if an individual uses a loan to make an investment that will result in taxable income, the interest benefit on the loan from the company is also eligible for deduction in the hands of the individual as a carrying charge.

Using a Corporation

A farm business can be carried on under any one of a number of alternative forms of organization; sole proprietorships, partnerships, joint ventures and corporations. While sole proprietorship is still the most common form of ownership, adopting a corporate structure can have many management, tax and estate planning benefits under certain conditions.

Key Strategies

Tax rates

Income tax rates for companies vary depending on the type and amount of income. The income tax rate on an Alberta company's first $500,000 of active business income is about 14 per cent or $70,000. On the same $500,000 of business income, an individual Alberta resident would pay tax of approximately $180,000.

On the surface, the corporate tax rate might seem to offer significant savings, but this savings is in fact only a deferral. Eventually, when funds are withdrawn as dividends, some additional personal tax will result. Currently, business income earned directly by a top-rate taxpayer results in almost the same total tax as when the income flows through a company and is paid out as a taxable dividend.

The real advantage is with respect to the portion of the earnings not paid out immediately by the company, and, therefore, the personal tax is deferred. This deferral is often for a very long time - in some cases, beyond the lifetime of the farmer.

Land

A farmer has the option of moving personally-owned land into a company or holding it personally. If land is held personally, the operations of the farming business, including the inventory, can still be transferred to the corporation.

A farmer may want to keep the land out of the company to preserve flexibility of future distribution. In a situation where children want to take separate parcels and go their own way, it will be difficult to transfer land out of the corporation without a negative tax impact.

Land held personally can be rented by the corporation. Where the land is mortgaged, the rent could be used to pay the interest. The Canada Revenue Agency does not seem to require fair market value rent but would likely find rental losses a problem where rent was not charged at a reasonable value.

Since active income earned in a corporation is subject to a lower rate of tax, there will be additional after-tax cash available to service the principal portion of long-term debt on land inside a company.

Land with an accrued gain can be transferred to a corporation, and the $750,000 capital gains exemption can be triggered (assuming the land qualifies and the exemption is available).

Farm houses and other buildings

Farmers have the option of owning their house personally or through a farming corporation. If the farmer owns the house personally, a reasonable portion of light, power, water, telephone and fire insurance is deductible as a farm expense. A reasonable portion of house repairs are also deductible. Capital cost allowance may also be taken on the dwelling in proportion to the business portion of the house.

Tips and Traps

✓ If the decision is made to retain ownership of the farmhouse personally, any capital cost allowance claim on a farmhouse may disqualify it for the principal residence exemption (potentially on the entire house value).

✓ Although the house is owned personally, expenses related to the house may be paid through the farming corporation. The proportion of the expense, such as utilities or property taxes relating to personal use, should be charged back to the shareholder. This can be done by way of a charge to the shareholder loan account, or as a wage to the shareholder or as a taxable benefit.

✓ A farmer may also personally own farm buildings other than the principal residence. As an alternative to having the farming corporation pay rent to use the building, the corporation could pay insurance for the building on the farmer's behalf in lieu of rent. Technically, a rental statement would be required, but presumably the rent would be offset by the expenses (you also need to consider GST issues).

✓ In certain situations, a company may build or make improvements on land owned by a farmer. A taxable benefit may arise even if a caveat indicates the company's ownership interest in these improvements. In addition, a potential legal issue exists as any permanent fixture on land is considered part of the land.

Income Splitting

✓ There is an opportunity to split income among family members by means of salaries and dividends and thus reduce total personal tax payable .

✓ In setting up a corporation, draft the Articles of Incorporation carefully. It may be important to have individuals subscribe for different classes of shares to allow for future income splitting by distributing dividends to different shareholders. See section on Income Splitting with Corporations.

Estate Planning and Transfers

✓ It is easier and less costly to transfer shares in a company than it is to transfer individual assets of a business.

Limited Liability

✓ While shareholder liability is usually limited to the amount invested in the company, lenders usually require shareholders to personally guarantee loans. However, limited liability can be important if the company is found liable in a lawsuit.

Family Involvement

✓ A properly structured company can allow family members to participate in the farm business and receive income while leaving the control of the business in the hands of one family member.

Corporation – Sale of Assets vs. Sale of Shares

If the decision is made to sell the incorporated business, two general approaches can be taken. The first is for the corporation to sell the assets of the business. The other approach is to sell the shares of the corporation.

If the shares are "qualified small business corporation shares" or "qualified farm property," the individual may be able to claim an exemption for up to $750,000 of the gain on the sale of shares. No capital gain exemption is available to the corporation if it sells the assets. So from the vendor's viewpoint, it is often preferable to sell shares.

The buyer of the business, however, will often prefer to purchase assets. One reason for this preference is that this approach will normally allow the buyer to claim higher capital cost allowance on the cost of the depreciable assets. If a sale of assets occurs, the corporation will have to pay tax on income, recaptured depreciation and capital gains. Tax planning should be done to minimize this tax.

Tips and Traps

Retiring Allowance

✓ In the sale of an incorporated farm business, it may be better to pay a retiring allowance to employees, such as the farmer and his wife, who have received employment income from the corporation in the past.

✓ Reasonable retiring allowances are a deduction to the company and can be transferred to the employee's RRSP. These allowances are limited to $2,000 per year of employment before 1996, plus $1,500 for any years of employment before 1989 for which employer's pension contributions have not vested. For very large retiring allowance transfers, alternative minimum tax should be considered.

Double Tax on Sale of Assets

✓ If the company is contemplating a sale of assets, consideration must also be given to personal tax to the extent that shareholders will withdraw funds from the company after the business sale. If dividends are to be paid, the dividend tax credit should be considered, and the possibility of recovering a portion of the tax paid on capital gains by the company should also be considered (refundable dividend tax on hand). Under this strategy, it may make sense to take out $30,000 of dividends annually (if the recipient has little or no other income – personal tax would be likely nil.)

Capital Dividend Account

✓ If a capital gain is incurred by a company, consideration should be given to paying out a tax-free capital dividend to the extent that one is available. This situation will often occur when assets are sold by the company. Whenever a company has the ability to pay a capital dividend (because of capital gains or additions from collecting on life insurance for example), the dividend should be paid since a subsequent capital loss or other reduction in the balance of the capital dividend account could remove the ability to pay the tax-free dividend.

Tips and Traps continued

Taxation

✓ A company is not eligible for the exemption from tax on capital gains for principal residence, nor is it eligible for the capital gains exemption. In addition, any benefits received by shareholders or employees are taxable unless a reasonable amount is paid for these benefits (see section on Taxable Benefits).

Corporate losses cannot be transferred to an individual to offset income from other sources as can losses from a proprietorship or partnership. Assets that are transferred tax free into a corporation cannot be subsequently withdrawn without triggering what might be a substantial tax liability.

Key Issues in Working with Companies

Land in or out?

In some situations, incorporation may make sense based on the income level of the farm operation, but there may be a reason not to put the actual farm land into the company. The farmer might simply prefer to keep the land. Or a farmer wishes to hold the land longer in the hopes of an increase in value that he or she might be able to use the capital gains exemption on (since a corporation does not have access to the exemption).

In these situations, all other farm assets including inventory and equipment may be transferred to the company (normally buildings are held personally with the land). The company can then enter into a lease agreement with the individual to lease the land for farming activities to be carried on by the company.

In this type of situation, consideration must be given to any debt that may be outstanding on the land and buildings. Since those assets are being kept personally, the debt would also be held personally in almost all situations.

In that case, care must be given that the company lease payments are enough to service the debt. Note that the lease payments cannot exceed a reasonable amount, or they will not be deductible to the company. In the case where reasonable lease payments would not be sufficient to make the personal debt payments, it may be necessary for wages or other forms of remuneration to be considered.

Note that lease income will be taxable to the individual farmer, and only the interest portion of the debt payments will be deductible against the lease income. Therefore, the individual farmer may be taxed on the portion of the lease payments used to make principal payments.

Also note that in this type of situation, it will be necessary to review the amount of debt (e.g. on equipment or operating loans) to ensure the corporation can assume those debts without tax consequences. It is often desirable to elect to transfer the inventory to the company under Section 85 at an elected amount of $1. For equipment, usually one would elect to transfer at a number equal to the undepreciated cost. If the debt to be assumed by the company exceeds these numbers, the debt cannot be assumed without increasing the elected amount and, therefore, resulting in current taxes.

It is necessary to consider whether GST should be charged on any lease payments made by the company to the individual.

Cash Basis Accounts Receivable

Most farmers are on a cash basis for income tax purposes. Many also have substantial accounts receivable at any given time for interim and final payments on crops previously delivered. Unfortunately, these accounts receivable do not qualify for tax-free rollover to a corporation. Therefore, when planning for the individual income once a company has been set up, allowance must be made for this income that will have to be reported personally. The income may come in over a year or two after incorporation.

Another option when considering incorporation is to collect on any accounts receivable possible (e.g. collect on previously deferred cheques) and then use the funds to purchase farm inventory prior to incorporation. In this manner, the individual farmer would have more personal income (collecting the cheques) initially, but this would be offset by the expense for the purchase of farm inventory. The inventory would be a qualifying asset for purposes of transfer to a corporation under Section 85.

Employment Insurance Considerations

In many cases, it is desirable to avoid employment insurance premiums on salaries paid to the farmer or spouse from their company. One method to avoid the requirement to pay the premiums on wages and salary paid from a company is to ensure the employee controls more than 40 per cent of the voting shares of the company paying the wage.

Therefore, two parties could be exempt from employment insurance premiums by ensuring each had more than 40 per cent of the votes. This outcome might be achieved by issuing voting shares that have no equity participation to the person who needs additional votes to reach the 40 per cent threshold.

Income Splitting with Corporations

A farmer using a farm corporation to operate has several options with respect to removing income from the corporation. A corporation is a separate legal entity and as such, there are specific methods to extract funds from the corporation. This situation is contrary to a sole proprietorship where the farmer has direct access to all earned income.

Dividends

Dividends are the distribution of a corporation's profits to its shareholders. Dividends are not deductible by the corporation. In the farmer's hands, dividends will be grossed up and eligible for a dividend tax credit. The personal tax rates on dividends are less than the rates on most other types of income.

Salary

Where the corporation pays the farmer a salary, the amount paid is deductible by the corporation and taxable to the farmer as employment income. The Canada Revenue Agency's position with regard to paying active owner/managers is to consider it a reasonable deduction regardless of the size of the salary. However, salaries to all other individuals must be reasonable.

Since small business corporations are eligible for significantly lower tax rates on taxable income below $500,000, a farmer may decide to pay out a bonus in addition to the base salary to ensure the corporation's income does not exceed the $500,000 level. However, with lower tax rates in recent years it may make sense to leave income over $500,000 to be taxed in the corporation as well.

Salary to Spouse and Children

The Canadian tax system uses progressive tax rates, so the marginal rate of tax increases as taxable income increases. The marginal rates for Alberta are approximately as follows:

- 25 per cent on income up to approximately $41,000
- 32 per cent on income from approximately $41,000 to approximately $82,000
- 36 per cent on income from approximately $82,000 to approximately $127,000
- 39 per cent on income over approximately $127,000

As a result of this progressive system, the incentive is there to pay tax on two salaries of $30,000 as opposed to one $60,000 salary. Therefore, taxpayers have the incentive to "split income" between a high-income earner and a lower income spouse or among children.

Where a farmer carries on business through a corporation, consideration should be given to paying a salary to the spouse or children. The salary must be "reasonable" in light of the services they perform in the business. Such services might include bookkeeping, filing, other administrative work and acting as a director of the corporation.

Tips and Traps

✓ The impact of payroll taxes, Canada Pension Plan contributions and employment insurance should be weighed against any potential tax savings expected from implementing this strategy.

Salary/Dividend Mix

When farming through a corporation, a farmer has the option of the combination of a salary and dividend mix when removing funds from the corporation. Careful analysis is required to determine what the appropriate salary/dividend mix should be for each situation.

The following considerations should be reviewed:

- The cash flow needs of the farmer;
- The income level of the farmer;
- The corporation's income level;
- The corporation's status for tax purposes.

Tips and Traps

✓ The farmer will usually want to have enough salary to allow a reasonable RRSP contribution.

Example of salary/dividend mix
Assuming Alberta resident with no non-refundable tax credits (other than basic exemption)

	Approx Personal Tax
$40,000 wage	$6,000
$20,000 wage/$20,000 ineligible dividend	$3,700
$40,000 ineligible dividend	$1,600

Note that payment of a wage would allow a deductible RRSP contribution for future years and allow access to Canada Pension Plan while a dividend would not. In addition, wages would provide a tax deduction for the company, resulting in lower corporate taxes.

Taxable Benefits from Corporations

Whenever an individual gets any benefit from a corporation, including the use of a company-owned asset for personal purposes, a taxable benefit will generally result that should be reported. Only a limited number of benefits an employee can receive are not taxable, including contributions to a registered pension plan and contributions to a group sickness or accident insurance plan.

Tips and Traps

Company-owned Automobiles

✓ The benefit for the personal use of a company-owned vehicle is made up of two items: a standby charge and the benefit in respect of operating costs. These items will normally be reported together on the employee's T4 form.

✓ The standby charge is essentially two per cent of the vehicle's original cost for each month it was available to the individual (i.e. 24 per cent for the year). This charge can only be reduced if it can be shown that both (a) the business use of the vehicle is more than 50 per cent of the kilometres driven and (b) your personal use of the vehicle is less than 20,004 km in the year.

✓ Where the vehicle is leased, the standby charge is two-thirds of the monthly lease cost instead of the two per cent of the purchase price.

✓ There are two options for calculating the operating cost benefit. Where the farmer establishes that the automobile is used more than 50 per cent of the time for business use, then the operating cost may be calculated as half the standby charge. Farmers who cannot use this method must compute the operating cost benefit at $.24/km (2011).

Allowance for Automobile Expenses

✓ Reasonable allowances based solely on the number of kilometres driven for business purposes are not included in the individual's income. The Canada Revenue Agency accepts as a "reasonable allowance" $.52/km for the first 5,000 km and $.46/km thereafter.

✓ A flat rate allowance not calculated based on kilometres traveled will be included in the individual's income.

✓ An effective strategy to minimize taxes for a vehicle used both for business and personal purposes is to have the individual purchase the vehicle personally. As a result, there is no taxable benefit for the use of a company-owned vehicle. Charge the company a reasonable allowance for business use using the per kilometre rates noted above. The outcome will be a deduction to the company for the per kilometre payment and no income inclusion for the individual. The individual should, however, pay all vehicle costs and will have a source of tax-free money to do so based on the per kilometre charge to the company.

Death of a Farmer

When the owner of a farm property dies, various tax consequences may occur. At the time of death, the farmer is subject to a deemed disposition. In other words, the taxpayer is considered to have disposed of any capital assets immediately prior to death and to have received proceeds equal to fair market value of those assets.

For all capital property, the fair market value must be determined, and the gain or loss resulting from the deemed sale must be declared on the deceased taxpayer's final tax return.

Where property qualifies under any of the rollover provisions, the deemed disposition rules do not apply. Where a farmer is gifting or bequeathing property to heirs, it is important to ensure the requirements of the rollover rules are met to defer the taxes on the property. Deemed disposition rules do not apply on a disposition to a spouse (unless elected otherwise).

Depreciable Assets

The deemed proceeds on depreciable assets of a prescribed class is an amount equal to fair market value of the assets in the class. The following example shows how this is calculated:

Example:

Capital cost	$8,000
Fair market value	6,800
Undepreciated capital cost	4,900
Deemed proceeds	6,800
Recaptured capital cost allowance	
Deemed proceeds –	
Unclaimed Capital Cost (UCC) =	$6,800 - 4,900
	$1,900

In the above example, the taxpayer will be deemed to have received proceeds of $6,800. The recaptured capital cost allowance for the assets in the class ($1,900) will be included in the taxpayer's income in the year of death. The deemed proceeds in the example are less than the capital cost, so there is no capital gain.

Where a capital gain occurs, one-half would be added to the deceased's income and, subject to the capital gains exemption, be taxed at normal rates.

Where a farmer has assets on the straight-line method of capital cost allowance, the assets are transferred at the fair market value without the incidence of recapture. The beneficiary of the asset must then claim capital cost allowance on the declining balance method. As well, the beneficiary is deemed to have acquired the property at a cost equal to the deemed proceeds of the deceased.

The rollover rules may apply for depreciable property being transferred to spouses or children. Under these provisions, declining balance assets can be transferred at their undepreciated capital cost.

Tips and Traps

- ✓ It may be best to exclude certain assets from the rollover provisions to make use of any remaining capital gain exemption. To avoid the normal spousal rollover in a transfer to a spouse, an election can be made by a letter attached to the tax return.

Actual Dispositions

The deemed proceeds of disposition established at death may vary from the amounts on an actual subsequent disposal. In this situation, the *Income Tax Act* permits an adjustment for losses incurred within twelve months after death. If the estate incurs either a capital loss or terminal loss, the deceased's income is recalculated taking this loss into consideration. In effect, the loss has been carried back to offset any gains accrued at the time of death.

An exception to the capital loss carry-forward provisions allows any unabsorbed capital losses in the year the taxpayer dies to be applied against any income for the year of death or for the immediately preceding year. However, these capital loss carry-forwards would not be available if the deceased had claimed the capital gains exemption in the year or in a prior year.

Cash Basis Considerations

Farmers on a cash basis may have inventories and receivables on hand at the time of death. Cash basis inventory and receivables are considered to be "rights or things." As a result, they may be reported on the deceased taxpayer's final return, included on a rights or things return or transferred to the beneficiaries (Canadian resident or not) to be taxed in their hands. Where the farmer was on the accrual basis of farming, the inventory and receivables would have to be included on the final return.

Optional and Mandatory Inventory Adjustments

An optional or mandatory inventory add-back is deducted in the following year (see the section on Inventory). When a taxpayer dies, any adjustment recorded on the last tax return would also be eligible for deduction on the rights or things return against the inventory income. This treatment would avoid a potential unusable loss on the final return.

Tips and Traps

- ✓ Where the inventory is transferred to a beneficiary, a loss will be created through the deduction of the prior year's inventory with no corresponding income to offset it.
- ✓ Additionally, the income will be fully taxed in the hands of the beneficiary.

Restricted Farmers

Restricted farmers are those whose chief source of income may not be farming (see the discussion under Losses). Restricted farmers are not eligible for all the loss deductions available to full-time farmers. However, if the taxpayer is carrying on the business of farming immediately before death, even as a restricted farmer, the farmer may qualify for a tax-free rollover.

Deferred Grain Sales

At the time of death, the farmer may have received a cash purchase ticket or a deferred cash purchase ticket from the public elevator. Farmers on the cash basis recognize the income when it is received. As a result, uncashed tickets held at the time of death are included as income on the rights or things return (or they can be taxed in the final return or transferred to a beneficiary).

Farm Crops

A farmer who farms land owned or rented or who rents farm land out through a crop share arrangement may have an interest in a standing crop (unharvested) at the time of death. The Canada Revenue Agency takes the position that the value of any interest in an unharvested crop does not have to be included in the final returns of the taxpayer. Where the value is not included in the final returns of the deceased, the eventual proceeds from the crop will be taxable in the hands of the beneficiaries or the estate.

The deceased taxpayer's legal representative may elect to have the value of the standing crop included in the taxpayer's final return where desirable. In the event the amount is included in the final return, the following conditions apply:

1. In the case of a deceased taxpayer who farmed land he owned or rented, the value of the deceased's interest in the crop at the time of death is included in income as a right or thing;
2. In the case of a deceased taxpayer who rented land in a crop share arrangement, the value of the deceased's interest at the time of death is included in his income on the final return. However if the legal representative takes advantage of the election provision, the value may be included as a right or thing.

Farm land owned by the deceased taxpayer may be sold after death but before the crop is harvested. Where there has been a sale, the value of the unharvested crop will not be included in the income of the deceased, the estate or the beneficiaries unless the agreement for sale, or other instrument, specifies the crop's selling price.

If the land rented by the deceased is not retained under lease by his or her estate or beneficiaries until the crop is harvested, no amount for the crop is included in the income of the group unless a payment regarding the crop is received upon or after the lease being relinquished. If the person harvesting the crop pays the specified price or makes such a payment on the lease being relinquished, then that person may deduct the amount in computing his or her income. Although the estate or beneficiaries may be subject to tax on the unharvested crop, they are not eligible to deduct any seeding or other expenses incurred by or allowed to the deceased taxpayer.

Miscellaneous Sources of Income

Surface Rentals and Farming Operations

People exploring or drilling for petroleum or natural gas often get a lease covering certain surface rights from the landowner. For example, the lease may cover several years of use of a small acreage of land, possibly set in from the owner's boundaries.

The first year's payment may be in a lump sum for such things as damage to land, land improvements, inconvenience, severance and the first year's rent, without a specific amount being ascribed to any of these items. For the second and subsequent years, the lease may require a periodic payment or payments for rental, severance, or inconvenience.

In these circumstances, the portion of the lump sum paid in the first year equal to the periodic payments to be made in subsequent years is considered to be income within the meaning of subsection 9(1) of the *Income Tax Act*. The remainder of the lump sum payment is generally considered to be capital.

The capital portion of the first year's payment as compensation for property affected, damaged or destroyed constitutes "proceeds of disposition" and may result in a capital gain or loss. The adjusted cost base for the portion of the property disposed of is the portion of the entire property's adjusted cost base reasonably attributable to the part under lease. The adjusted cost base of the whole property is then decreased by that amount.

Where the part disposed of is relatively small in relation to the overall property, The Canada Revenue Agency accepts any reasonable portion of the adjusted cost base the taxpayer wishes to attribute to the proceeds.

Where a specific amount is stated in the lease (or in a supplementary letter) for each of the various items included in the first year's payment, normally only those amounts for recurring items are considered income. An item may recur even though the amounts payable for it differ in the first and subsequent years.

The portion of the first year's payment specified for damage to growing crops is considered to be income rather than capital. Income payments to a farmer actively engaged in farming the land, part of which is the subject of the lease, are income from the business of farming.

Tips and Traps

✓ A reassessment originating in Saskatchewan included a seismic payment in income. The Canada Revenue Agency took the position that shot holes no longer occur, and the running of seismic lines across farmland does not cause damage other than packing the soil (which can be repaired using tillage equipment). Therefore, the payment was considered income.

✓ In a private interpretation, the Canada Revenue Agency indicated that a portion of the land's cost base must be allocated to the proceeds of disposition (i.e. it was not acceptable to use the capital gains exemption to fully offset the proceeds).

Sale of Gravel, Sand or Topsoil

The sale of sand, gravel, topsoil, similar substances and sod is considered to be farm income where:

- amounts received depend on the use of or production from property contingent on the quantity of material taken at some rate or standard (such as a price per ton or per cubic yard); or
- the sale constitutes business income.

For a sale to be treated as income, it is only necessary to establish that one of the above criteria apply, although in many cases both will apply.

Instalments of the sale price of agricultural land are not generally treated as income. However, amounts received on the sale of earth substances extracted from farm land are not considered instalments of the sale price of agricultural land and, consequently, may be treated as income.

Tips and Traps

✓ In deciding whether or not the profit resulting from the sale of earth substances is income, the courts have applied the following tests:

- The taxpayer's intentions regarding the earth substances during the ownership period of the property.
- The taxpayer's whole course of conduct indicates that in dealings with earth substances, he or she is disposing of them in a way capable of producing profits and has that object in view. The transactions are of the same kind, and they are carried on in the same way as those of ordinary trading in that substance.

✓ Should the following factors exist, they provide additional evidence to indicate a taxpayer is in a business; however, by themselves, these factors are not enough to constitute a finding that a transaction is a business:

a. the substances are advertised and are available for sale to the general public;

b. an organization is established by the taxpayer for the sale of the substance;

c. the taxpayer is involved in the removal of the substances;

Tips and Traps continued

d. the number of sales is not limited to a single or isolated transaction; and

e. the transaction is similar to other activities that the taxpayer has entered into before or since.

✓ Situations may occur where a taxpayer sells the land that contains the substance rather than selling the earth substance itself. If the amount received reflects the value of the substance, proceeds from the transaction may be treated as an income receipt or a capital receipt depending on the circumstances of the case - see d. and e. above. Consider the example in which land that normally has a fair market value of $150 per acre is sold for $1,500 per acre because of the value of the earth substance.

✓ However, if the sale terms require payments based on substance production over a period of time, the instalments are considered income regardless of whether or not the taxpayer is seen to be carrying on an adventure in the nature of trade as in a business.

✓ An aggressive approach to avoiding income treatment on the sale of gravel may be to sell the land instead of the gravel, claim the enhanced capital gains exemption on the land and lease back the land for farming.

Patronage Dividends

All patronage dividends with the exception of those for personal goods or services are taxable in the hands of the farmer when received. Where the payment has been made in the form of a share or certificate of indebtedness, the patronage dividend is deemed to be received by the customer.

For example, farm co-operatives often declare dividends, but the farmer receives only partial cash consideration. For income tax purposes, however, a farmer is required to pay tax on the cash received plus that portion of the dividend retained by the co-operative and converted to equity.

Tips and Traps

✓ These patronage dividends should be included on the statement of farming income and expense.

✓ They are not eligible for the dividend tax credit.

✓ The co-operative will often withhold tax from the dividend. When reporting the income on the farm statement of income and expense, be sure to report the dividend's gross amount.

✓ The tax withholding can be claimed on the farmer's income tax return as an amount paid by instalment.

Dividends received for personal items are not to be recorded for tax purposes as income; however, the tax withheld can still be treated as an instalment.

Sales of Farm Land Including the Crop

Where an agreement for the sale of farm land with a standing crop specifies the amount payable for the crop, the amount specified is considered income to the vendor and an allowable deduction to the purchaser. Where the agreement does not specify an amount payable for the crop, no portion of the sale price may be attributed to the crop as far as either the vendor or the purchaser is concerned.

Sales of Rights to Harvest Crops

A taxpayer in the business of farming may choose to retain title to the farm and merely sell the right to harvest the crop from it. In this situation, the consideration paid for that right is considered income to the vendor and an allowable deduction to the purchaser for tax purposes.

Farmers - Farm Produce Consumed

The cost value of all materials or produce that were stock in trade and could have been sold as such consumed by a taxpayer in the business of farming should be deducted from the otherwise allowable farm expenses. The same conditions apply for produce from the farmer's home garden. Expenses incurred in producing for personal consumption rather than for sale should be excluded from the farm operating expenses. This is often accomplished by an add-back to income for personal consumption.

Exchange of Goods

Where a taxpayer in the business of farming receives goods or services in exchange for farm products, the fair market value of the farm products given by the taxpayer in exchange must be included in his or her income. The value of the goods or services received in exchange by the taxpayer may possibly be expensed or capitalized, depending on what is received.

For example, if a taxpayer exchanges wheat for repairs made to a tractor, the value of the wheat would be added and the value of the repairs would be deductible in computing farm income.

Destruction of Livestock

Situations may occur where livestock need to be destroyed, such as under the *Animal Contagious Disease Act*. An amount received or receivable (depending on the method regularly followed in computing income) by a taxpayer in the business of farming as compensation under statutory authority for the forced destruction of livestock is considered income.

Section 80.3 permits the deferral of reporting of this amount to the year following that in which it was received or receivable. This deferral is not available in the taxation year during which a taxpayer dies or ceases to be resident in Canada or in any subsequent year.

Sale or Lease of Marketing Quotas

An amount received or receivable (depending upon the method regularly followed in computing income) by a taxpayer for granting a farmer permission to use the taxpayer's marketing quota (e.g. milk) is considered income. This amount will be treated as income from farming if the taxpayer is engaged in a farming business. The sale of the actual quota by a farmer would be considered to be the disposition of an eligible capital property.

Mineral Rights

Farmers and others who own gas and oil mineral rights could have serious income tax liabilities when the ownership of these rights changes through transfer by way of sale, gift or bequest.

For income tax purposes, Canadian resource properties are added to a Canadian oil and gas property expense account that functions similar to a capital cost allowance schedule for depreciable assets.

The rollover provisions of the *Income Tax Act* may apply to resource properties. These provisions will apply where the resource property is transferred to a spouse or spousal trust. The transfer may take place at any elected amount up to fair market value of the property.

Transfers of resource property to children or any other person must take place at fair market value. The full amount of the deemed proceeds resulting from the transfer must be brought into the income of the transferor in the year the transfer takes place. A mineral right does not qualify for the family farm rollover provision.

Resource properties can be rolled into a partnership or corporation on a tax-deferred basis. The owner of the mineral right will receive a partnership interest or corporate shares that reflect the value of the mineral right transferred. Any increase in the value of the mineral rights can be divided among the other partnership members or shareholders.

On the death of the original holder of the partnership or corporation's mineral rights, the estate will be receiving shares or a partnership interest and not the actual mineral right. Any tax liability on the shares or partnership interest will likely be a capital one.

The revenues received by a company from "leasing" mineral rights would usually be considered income from property taxed at the highest corporate tax rate rather than active business income eligible for the small business tax rate.

Tips and Traps

✓ Consider using a bare trustee corporation to transfer the mineral rights. In this manner, a party interested in leasing the rights may only have to deal with one contact (the bare trustee) rather than contacting several individuals with respect to a particular mineral right title. However, the corporation does not have beneficial ownership and for tax income reporting purposes, the individual would still be considered the owner.

✓ Consider transferring mineral rights to a corporation. By transferring the rights to a company, it may be possible to freeze the value of the rights at current amounts (to cap the tax exposure). In this way, the deceased will have a deemed disposition of a share instead of mineral rights that should result in a capital gain of which 50 per cent is non-taxable rather than fully taxable deemed disposal of mineral rights.

Grazing Leases

Grazing leases often have significant value and, as a result, two questions often result:

Can the purchase of a grazing lease be depreciated?

Technically, it would appear a purchase of a grazing lease would normally qualify as a Class 13 asset (see comments in Paragraph 22 of Interpretation Bulletin 464).

Is the sale of a grazing lease eligible for the enhanced capital gains exemption?

The answer to this question is not totally clear. In one private interpretation, The Canada Revenue Agency took the view that a grazing lease does not qualify. The department supported this position on the following basis. While Section 248 of the *Income Tax Act* indicates that an interest in real property includes a leasehold interest in real property, the definition in Subsection 110.6 (1) regarding the capital gain exemption refers only to real property (and not an interest in real property). However in another interpretation, The Canada Revenue Agency did feel the gain on a sale of a grazing lease was eligible for the exemption.

Timber Sales

A farmer may receive proceeds from the sale of timber located on existing farm land or as a part of clearing land to be used for farming purposes. The tax treatment of these proceeds depends on the given situation.

The Canada Revenue Agency has indicated that the determination of the treatment of timber proceeds as income or capital (potentially eligible for the capital gains exemption) depends on a number of factors including:

A. The status of the underlying land (i.e. used in farming, held for investment, purchased with the intent of selling the standing timber);

B. Whether the trees were removed by the taxpayer-owner of the wood lot or by some other person;

C. Whether the payment received for the timber is a fixed price for a fixed quantity of timber to be taken within a fixed time or an amount related to the use of or production from the wood lot on a continuing basis; and

D. Whether the taxpayer-owner is involved in farming activities.

The Canada Revenue Agency has indicated, in general terms, that where a taxpayer acquires land with the specific intent of selling timber, the taxpayer is considered to be in the business of logging. Therefore, amounts received by the taxpayer for sales of timber are business income.

If, on the other hand, the selling of timber was not the motivating factor for the purchase of the land, amounts received by the taxpayer would likely be considered capital receipts.

If a farmer uses timber proceeds to reduce the cost base of the underlying farm land so that no cost remains, the question is whether any additional proceeds from timber sales would be eligible for the $750,000 capital gains exemption. The Canada Revenue Agency has indicated that to qualify for the exemption, timber sales must be viewed as a disposition of real property used in carrying on a farming business in Canada.

The Canada Revenue Agency views the timber as an asset not distinct from the land on which it stands and has indicated the enhanced capital gains exemption could only be claimed in respect of a disposition of the land. This position appears to indicate that the underlying land would need to be sold with the timber to have any opportunity to claim the enhanced exemption - assuming the land would otherwise qualify for the enhanced exemption.