Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Incorporating your farm

Is it the right option for you?

Statistics Canada conducts the Census of Agriculture (Census). The latest Census, completed in 2016, indicated that there are about 193,500 Canadian farms, comprising over 150 million acres of land. While there are several ways to structure the ownership of these farms, the most common are a sole proprietorship, a corporation or a partnership. Running a farm as a sole proprietorship is probably the easiest solution. In fact, according to the Census, over 51% of farms operate as sole proprietorships. However, incorporation may provide certain benefits, such as tax deferral, income splitting opportunities and access to certain estate planning strategies. This article highlights some factors you may want to consider when determining whether you should incorporate your farm.

The terms "corporation" and "company" are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation that is not controlled by a non-resident of Canada or a public corporation, or a combination of both. In addition, no class of shares of a CCPC can be listed on a prescribed stock exchange.

Any reference to spouse in this article also includes a common-law partner.

Advantages of incorporation

There are several potential advantages to incorporating your farm. The following is a non-exhaustive list of these advantages:

Tax deferral and the small business deduction

Perhaps the most significant advantage of operating your farm within a corporation is the ability to defer taxes. Farming income earned within a corporation is taxed at two levels – once at the corporate level and then again at the personal level when the income is distributed. By incorporating and earning farming income within your corporation, you can defer personal taxation on the farming income until you withdraw it

from your corporation. Generally, the longer you can leave the funds in your corporation, the greater the deferral advantage will be.

This tax deferral is available because income earned from operating your farm within a corporation may be taxed at lower corporate tax rates than farming income earned while operating as a sole proprietor (an unincorporated farmer). If the farming income is earned by your farm corporation, the taxable income may be considered active business income (ABI) for tax purposes and be subject to the general federal corporate tax at 15% plus the applicable provincial or territorial tax rate. Further, if your farm corporation is a CCPC throughout the tax year, your farm corporation may benefit from the small business deduction (SBD) which lowers the federal tax rate to 9% on its first $500,000 of ABI (known as the "business limit"). Both the federal and provincial business limits must be shared by associated corporations. The concept of association is defined in the Income Tax Act; it is complex and is beyond the scope of this article.

As a result of these lower corporate tax rates for ABI, if you incorporated your farming business, you may have more after-tax business income to invest inside your farm corporation. Due to the larger amount of starting capital, you may realize returns that exceed what you may have realized in a personal investment account.

In an attempt to limit this tax deferral benefit for corporations, the federal government has introduced rules to restrict access to the SBD for CCPCs, including farming corporations that have significant income from passive investments. For taxation years that begin after 2018, a corporation will have its federal business limit reduced on a straight-line basis where the corporation and its associated corporations earn between $50,000 and $150,000 of passive investment income in a year. The business limit will be reduced by $5 for every $1 of passive investment income above the $50,000 threshold. The business limit will be eliminated when the corporation, and its associated corporations, earn at least $150,000 of passive investment income in a year. As such, you may want to ensure the passive investment income earned in your farm corporation does not grind down your business limit. Please note that "investment income" does not include the sale of assets that are used in an active business, such as farmland or a quota.

In addition to the reduction described, the business limit is reduced on a straight-line basis for a corporation and its associated corporations where the group has between $10 million and $15 million of total taxable capital employed in Canada. The actual reduction of a corporation's business limit is the greater of the reduction based on taxable

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capital employed in Canada and the reduction based on passive investment income.

All provinces and territories also provide a SBD and have a business limit. In particular, additional criteria must be met in order to qualify for the Quebec SBD. Speak with a qualified tax advisor for more information regarding the SBD and business limit for a specific province or territory.

Retirement of debt

As explained earlier, income earned inside a farm corporation may be eligible for the SBD, which allows a corporation to have its income taxed at a lower rate. By reducing the taxes paid, the farm corporation will have more funds to repay its outstanding debt than it would if the farm was structured as a sole proprietorship. The farm corporation may be able to pay off its debt faster and thus reduce the total amount of interest it has to pay.

Income splitting opportunities

Incorporating a farm may allow you to take advantage of income splitting opportunities. By having lower-income-earning adult family members as shareholders, the incorporated farm may be able to pay them dividends to take advantage of their lower marginal tax rates. That being said, it's important to note that there are "tax on split income" (TOSI) rules which limit splitting certain types of income with family members.

These TOSI rules apply to many types of income received from a private corporation, including interest and dividends, as well as certain capital gains. Where TOSI applies, the income is subject to tax at the highest marginal rate, regardless of the individual's actual marginal tax rate. In addition, the individual who receives split income loses the ability to claim personal tax credits on the split income, such as the basic personal tax credit.

There are some exclusions to TOSI, which differ depending on the age of the individual receiving the income. The age categories include minors under age 18, adults age 18 to 24, and adults age 25 and over. There's also an exclusion available to the spouse of a business owner who's age 65 or over. The exclusions mainly rely on whether the family

member is significantly involved in the business or owns a certain portion of the votes and value of the corporation's shares. The exclusions are generally more restrictive for minors. For more information on the TOSI rules, please ask your RBC advisor for our article discussing income splitting through private corporations.

There are other ways you can income split with family members. One method is to pay reasonable salaries to lower-income family members for the services they provide, allowing family members to take advantage of their lower marginal tax rates and generate registered retirement savings plan (RRSP) contribution room. Your farm corporation can claim a deduction for the reasonable salaries paid or, if you're not incorporated, you can deduct the reasonable salaries from your farming income.

Lifetime capital gains exemption (LCGE)

The LCGE allows you, as a resident of Canada, to shelter up to $1,000,000 of realized capital gains when you sell farm property that's "qualified farm property" where certain criteria are met. Qualified farm property includes farmland and buildings used in carrying on a farm business, shares in a family farm corporation, an interest in a family farm partnership and property included in class 14.1 (formerly eligible capital property) for the purposes of capital cost allowance, such as quotas.

By incorporating your farm, you may be able to utilize the LCGE to shelter the growth on certain assets from tax, which if sold on its own, would result in taxable income to you. For example, inventory is not qualified farm property and, if sold on its own, the sale of inventory would result in taxable income to you. However, if you sell shares of a family farm corporation, you may qualify for the LCGE even if the corporation owns inventory and other assets, such as equipment that do not meet the criteria of qualified farm property.

Please ask your RBC advisor for our article titled "Selling the farm and the lifetime capital gains exemption" for more information.

Each individual shareholder is entitled to claim a LCGE during their lifetime on the disposition of qualified farm property. By incorporating, you and your family may be able to multiply the LCGE on the disposition of the shares of a family farm corporation if you and your family members own shares of such a corporation, directly or indirectly. The process of adding family members as shareholders of your corporation is complex and may result in immediate tax consequences. Speak to a qualified tax and legal advisor for more information regarding a reorganization of your corporation.

By incorporating your farm, you gain access to different forms of remuneration, for example, salary, dividends and bonuses.

Transfer to children on a tax-deferred basis

You may be able to transfer qualifying farm assets that you own personally to your children on a tax-deferred basis if certain conditions are met. This tax-deferred rollover is not available on the transfer of certain types of property such as inventory. If you're planning to transfer your farm to your children and the assets you're transferring include inventory that has appreciated in value, speak with a qualified tax advisor to determine if transferring the farm assets into a corporation and then transferring the shares of the corporation to your children makes sense in your circumstances.

Implementing an estate freeze

An estate freeze refers to a transaction where you lock in or "freeze" the value of appreciating assets. The intent is to transfer the future growth of the assets and their associated tax liability to other taxpayers, usually family members. Incorporating your farm may allow you to freeze the value of your farm at a certain point in time. The future growth can accrue in the hands of future generations, thus limiting your tax liability. You may also be able to take advantage of the LCGE when you implement the freeze. This strategy is discussed further in the article titled "Transferring your farm to the family".

Flexibility in remuneration

By incorporating your farm, you gain access to different forms of remuneration, for example, salary, dividends and bonuses. The ability to select the type and amount of remuneration allows you to maximize tax deferral while still taking advantage of benefits such as RRSP contribution room and participating in the Canada Pension Plan or the Quebec Pension Plan.

Employee benefits

By incorporating your farm business, you gain access to certain types of employee benefits or retirement savings plans, such as an individual pension plan (IPP) and a retirement compensation arrangement (RCA) that would otherwise not be available if you were a sole proprietor or a partner in a partnership.

Implementing an IPP

An IPP is a defined benefit pension plan that a corporation, including an incorporated farm, can establish for its owner or key employees. The IPP is not available to

unincorporated individuals (including unincorporated farmers). It's usually established for one individual member, but the benefits can be extended to your spouse and other family members if they are employed by the family farm corporation. In certain situations, an IPP can provide greater annual contribution room than an RRSP. Contributions made to an IPP are deductible from the incorporated farm's taxable income. An IPP may be ideally suited for individuals over age 40 and who earn significant employment income. For more information on IPPs, please ask your RBC advisor for the article on this topic and speak with a qualified tax advisor to determine if an IPP is right for you.

Implementing an RCA

An RCA can provide you with supplemental pension benefits so that you may maintain your standard of living in retirement. Typically, an RCA is part of a retirement plan, which may also include a registered pension plan (RPP) such as an IPP set up by the company. An RCA may also be able to provide pension benefits in instances where a company does not have an RPP.

For a more detailed discussion of an RCA, please ask your RBC advisor for the article on this topic and speak with a qualified tax advisor to determine if an RCA is right for you.

Corporate-owned life insurance

A corporate-owned life insurance policy may provide tax-exempt income protection for survivors or help fund the payment of taxes upon your death. Life insurance premiums are generally not tax-deductible. However, it's usually less expensive to fund the policy using after-tax corporate dollars as opposed to after-tax personal dollars, since income earned in a corporation may benefit from the low small business rate or general corporate tax rates.

Provided the corporation is both the policyholder and beneficiary of the insurance policy, you will generally not be assessed as having received a shareholder benefit (so there's no immediate tax consequence to you). A corporate life insurance policy will generally pay the non-taxable death benefit to your incorporated farm. This increases your corporation's capital dividend account (CDA) by the amount of the insurance proceeds received in excess of the policy's adjusted cost basis. The surviving shareholders can receive tax-free dividends paid from the CDA. Alternatively, the executor of your estate may be able to redeem your shares of the corporation and flow the CDA balance to your estate.

You need to be aware that the cash surrender value of the life insurance policy is not an active farm asset. To qualify for the LCGE, a minimum amount of the assets in the corporation must be used in active farming. If the total of the non-active farming assets, such as the cash surrender value of the life insurance policy, is large enough, you may no longer qualify for the LCGE on the sale of this property.

> A corporate-owned life insurance policy may provide tax-exempt income protection for survivors or help fund the payment of taxes upon your death.

Please consult with a licensed life insurance representative to learn more about your insurance options.

Liability issues

Incorporation generally limits the liability of a corporation's shareholders. This means the shareholders of a corporation are generally not responsible for the corporation's liabilities unless they've provided a personal guarantee. However, if a shareholder is also a director, that person could be liable for certain corporate liabilities (which may include unpaid wages and payroll taxes) in their capacity as a director. Speak with a qualified legal advisor to determine your exposure to liability and whether you should implement any asset protection strategies.

Disadvantages of incorporation

While incorporating your farm may provide certain benefits, you will want to weigh these benefits against the potential disadvantages, such as the initial and ongoing accounting and legal costs of incorporation. Professional legal and accounting advice will be required to set up a corporation and ensure the proper records and legal documents are completed. Ongoing tax returns and other filings may be required. Some of the other disadvantages of incorporating are discussed in the following sections.

Restricted use of losses

In the first few years of operation, a farm may generate losses due to high start-up costs. If your farm is not incorporated, you may be able to use your farm losses to offset other sources of personal income. If your farm is incorporated, any farming losses must be applied to the corporation's income and cannot be used to offset personal income. Whether you incur these losses as a sole proprietor or through your farm corporation, if you can't use the losses in the year they are incurred, they are not completely lost. Farm losses can generally be carried back three years and forward for 20 years to offset against past or future income.

Please note that special rules apply to farm losses that are realized in cases where farming is not your main source of income. In such a case, you may only be able to deduct

part of your farm loss. Speak with a qualified tax advisor for more information regarding this matter.

Principal residence exemption

The principal residence exemption is available to a Canadian resident individual but not to a corporation. Consequently, if your incorporated farm holds and sells your principal residence, it will not have access to this exemption on any realized capital gains. Further, if the corporation holds an asset that you, or related parties, use for personal purposes, you may be deemed to have received a shareholder benefit. The value of the shareholder benefit is included in your personal taxable income each year. If your principal residence is located on your farm property and you are planning to incorporate, consider keeping your principal residence (and generally up to half a hectare of surrounding land) in your personal name to utilize the principal residence exemption in case of a future sale.

Restricted personal use of corporate funds

All of the farming income you earn as a sole proprietor is taxed in your hands annually. As such, you can use the after-tax profits however you wish. On the other hand, if you incorporate your farm business, the after-tax profits belong to the corporation, and you can't use the corporate funds for personal expenses unless you first withdraw the money from the corporation. Depending on how you withdraw funds from the corporation (e.g. as salary, bonus or dividend), you will face different tax implications on the withdrawal.

Less flexibility with succession planning

If owned personally, you may be able to divide your qualified farm property, such as land, and transfer different portions on a tax deferred basis to your children. You would not be able to choose which properties are transferred if this property is held in a corporation.

The ability to select the properties that are transferred may help you overcome potential family issues. For example, if you have two children with different views of farming, and you own 1,000 acres of farming land personally, you could transfer 500 acres to each of your two children for them to carry on their own separate farming businesses. This would allow both to continue farming, separate from one another, thereby reducing or eliminating the possibility of conflict. If this land was held in a corporation, your gift to each child would be shares of the corporation, requiring them to work together on the farming operations.

When deciding to establish a corporation for your farming business, keep in mind, not all farming assets have to be transferred to the corporation. It may make sense to hold some of these assets personally to provide more flexibility in your succession plan.

> The principal residence exemption is available to a Canadian resident individual but not to a corporation.

Should you incorporate?

After familiarizing yourself with some of the advantages and disadvantages of incorporating, here are some questions you can consider when determining whether you should incorporate your farm business:

- Do you have family members that are in lower marginal tax brackets? If so, incorporating may allow you to benefit from the income splitting strategies discussed earlier. Be mindful of the TOSI rules.
- Do you have significant sources of non-farm income that may provide you with sufficient cash flow? If so, it may make sense to incorporate your farm. If incorporated, the farm income will be subject to the lower corporate tax rates, as opposed to your high personal marginal tax rate. You may achieve tax deferral by keeping the profits inside the corporation and determine the timing of remuneration. Be mindful of the grinding down of the business limit when earning passive investment income in your family farm corporation.
- Do you need all or a substantial portion of your total farm and non-farm income for your annual living expenses and financial goals? If so, incorporating your farm may not make sense. You may not be able to benefit from the tax deferral a corporation can offer if you need to receive a significant amount of the corporation's income as salary or dividends to support your lifestyle expenses.
- Is your farm operation in a loss position? As mentioned, if your farming business is your chief source of income, farm losses incurred personally can be used to offset other sources of income, which will reduce your overall tax burden. Losses incurred in a corporation can't be used to offset personal income, so it may not make sense to incorporate your farm if you're generating farm losses.
- Are the potential tax savings from incorporating greater than the fees associated with establishing a corporation and the ongoing costs of maintaining the corporation? As mentioned earlier, establishing a corporation can be expensive and complex and these costs should be considered in the context of the tax savings that can be achieved by incorporating.

There are multiple factors to consider when determining whether incorporating your farm is the right decision

for you. Incorporating your farm may have long-term ramifications. Consult with your professional financial, tax and legal advisors prior to making this decision.

Farm partnerships

An alternative farm ownership structure is a farm partnership. This may be created between family members or between unrelated parties. Advantages of this structure include:

- Similar to a farm corporation, it provides an opportunity to split income among the partners and may therefore reduce overall total taxes paid;
- It allows an individual to add their children as partners. This gives the children the opportunity to gain experience with the farm and the parents the potential to ease into retirement if that's their goal;
- Losses distributed by the partnership can be utilized on the partners' personal tax returns subject to certain limitations; and
- The LCGE is also available for the sale of family farm partnerships when certain criteria are met.

Disadvantages to this structure include:

- You're potentially liable for the actions of other partners;
- Your assets outside of the partnership are potentially exposed to the claims of creditors whereas creditors of the corporation generally can't access your personal assets; and
- A partnership is a flow-through entity. Its income is allocated to the partners annually and taxed at their individual tax rates. Thus a partnership is not eligible for the lower small business tax rate or general corporate tax rate.

If you decide that a family farm partnership makes sense for you, you and your partners should consider developing a partnership agreement. A strong partnership agreement details the rights and obligations of the partners relating to the partnership and typically includes the ownership of the assets, the division of profits and losses, the methodology by which disagreements are resolved and the ability to buy the interest of other partners.

Summary

The ownership structure of your farming business may impact your financial planning goals and your family situation. Incorporating a farm certainly has benefits but it may not make sense for everyone. It's important to consult with legal and tax advisors to determine which structure is best for your farming business.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Wealth Management

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