Wealth Management

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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Incorporating your farm

Is it right for you?

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The 2016 Census of Agriculture 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 of Agriculture, over 51% of farms operate as sole proprietorships. However, incorporation may provide certain benefits, such as the potential for lower tax rates, income splitting opportunities and access to certain estate planning strategies. This article highlights some factors that 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.

The term "spouse" used in this article also refers to common-law partner or same-sex 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. You can defer personal taxation on the after-tax farming income until you withdraw it from your corporation.

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 as 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, your farm corporation may benefit from the small business deduction (SBD) which lowers the federal tax rate to 10% for 2018 and 9% for 2019 on its first $500,000 of ABI (known as the “business limit”). All provinces and territories also have a business limit. Speak with a qualified tax advisor to determine the limit for your specific province or territory of residence. Both the federal and provincial business limits must be shared by associated corporations[1].

The low tax rates on ABI provide a significant tax deferral advantage since it allows more funds (the deferred taxes) to accumulate within your corporation, which can be used to invest and earn additional income. The longer you can leave the funds in your corporation, the higher value of the deferral advantage.

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 corporation 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 that the passive investment income earned in your 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 above, 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 capital employed in Canada and the reduction based on passive investment income.

1) The term “associated corporation” is defined in the Income Tax Act. The definition is complex and is beyond the scope of this article.

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Retirement of debt

As explained above, 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 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 is 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, dividends, as well as certain capital gains but they do not apply to salaries or bonuses. 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 creditson 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 is also exclusion available to the spouse of a business owner who is age 65 or older. The exclusions mainly rely on whether the family member is significantly involved in the business and the exclusions are generally more restrictive for minors. For more information on the TOSI rules, please ask an 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 are not incorporated, you can deduct the reasonable salaries from your farming income.

Lifetime Capital Gains Exemption (LCGE)

The LCGE allows you to shelter up to $1,000,000 of realized capital gains when you sell your farm property that is “qualified farm property” and 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 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 that do not meet the criteria of qualified farm property.

Our article titled “Selling the Farm and the Capital Gains Exemption” discusses the criteria for a corporation to qualify as a family farm corporation.

Each individual shareholder is entitled to claim a LCGE during their lifetime on the disposition of qualified farm property. By incorporating, you may be able to add family members as shareholders of the family farm corporation. This may allow your family to multiply the LCGE on the future sale of the corporation.

Implementing an estate freeze

Incorporating your farm may allow you to freeze the value of your farm at a certain point in time. The future growth will 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.

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Implementing an Individual Pension Plan (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 is 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 the age of 40 and earn significant employment income. Speak with a qualified tax advisor to determine if an IPP 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 is 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 is 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 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 non-active farming assets, such as the cash surrender value of the life insurance policy, are large enough, you may no longer qualify for the LCGE on the sale of this property.

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

Liability issues

The creditors of your unincorporated farm could seize your personal assets for any outstanding business debts. Since a corporation is a separate legal entity, the creditors of your farming corporation generally cannot seize your personal assets unless you have given personal guarantees on loans to your corporation that have gone into default. Note that any asset protection strategy may not be effective where there are existing creditor claims or potential creditor claims. Always consult a qualified legal advisor before exploring the asset protection options available to you.

Ability to transfer inventory to children on tax-deferred basis

You may personally transfer farm assets to your children on a tax- deferred basis if certain conditions are met. This tax-deferred rollover is not available on the transfer of inventory. If you are planning to transfer your farm to your children and the assets you are 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 transfer the shares of the corporation to your children makes sense in your circumstances.

Non-tax related benefits

A corporation may also offer non- taxable benefits that are not available to sole proprietors. These benefits may include:

- Group disability benefits;
- Health insurance; and
- Benefits under a Registered Pension Plan

Disadvantages of incorporation

While incorporating your farm may provide certain benefits, you may weigh these benefits against the potential disadvantages of incorporating, such as the initial and on-going accounting and legal costs of incorporation. Professional legal and accounting advice will be required to set up a corporation and ensure that 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 below.

Use of losses

In the first few years of operation, a farm may generate losses due to high start-up costs and/or the cost of building a sales base. Generally, farm losses can be carried back three years or forward for 20 years before

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they expire. 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.

Please note that special rules apply to farm losses that are realized 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 an 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 up to half a hectare of surrounding land) in your personal name to utilize the principal residence exemption in case of a future sale.

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 could help you overcome 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.

Should you incorporate?

When deciding whether to incorporate your farm, you may wish to consider the following:

- 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 above. 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 above, 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 cannot be used to offset personal income so it may not make sense to incorporate your farm if you are generating farm losses.
- Are the potential tax savings from incorporating greater than the fees associated with establishing a corporation and the on-going costs of maintaining the corporation? As mentioned above, 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.

As you can see, 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.

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Farm partnerships

An alternative farm ownership structure is a farm partnership. This may be created between family members (i.e. individual, his/her spouse, and their children) 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 for the parents to ease into retirement if that is their goal;
- Partnerships typically involve less initial and on-going costs than corporations;
- 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 farm partnerships when certain criteria are met.

Disadvantages to this structure include:

- You are 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 cannot 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 farm partnership makes sense for you, it is highly recommended that you and your partners develop 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 all. It is important to consult with legal and tax advisors to determine which structure is best for your farming business.

This article may contain several 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.

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