TAX BULLETIN

INCORPORATING YOUR FARM BUSINESS

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If you carry on a farm business, and have significant income, transferring the farm business to a corporation may provide some benefits as there are tax planning opportunities which become available to you by simply incorporating. By transferring your farm business to a corporation, you become the shareholder and employee of a separate taxable entity. If the corporation qualifies as a Small Business Corporation (SBC) or a Family Farm Corporation (FFC), other possibilities arise. One point to keep in mind is that although the tests are different, many FFCs will qualify as an SBC.

This bulletin discusses some of the benefits of incorporation and the additional advantages that could apply if your company qualifies as an SBC or an FFC. Whether you're thinking about incorporating or have already done so, you should consider making full use of these tax planning opportunities.

Before we begin our discussion of incorporating your farm business, we will briefly review the option of calculating your taxable income under the cash basis versus the accrual basis. Note that this option will also exist if you incorporate your farm business.

While other corporate taxpayers must use the accrual method of reporting their income for tax purposes, FFCs are in a unique position as they have the option to use the cash method to report income for tax purposes. Under the cash method, farm corporations only have to report the actual cash receipts from the sale of farm products in their taxable income. Most businesses must report their income on an accrual basis. In addition, farm corporations can generally deduct expenses on a cash basis — this means that they can deduct the cost of purchasing inventory such as seed or livestock, even if the inventory is still on hand at year-end. Note that this rule does not apply to prepaid expenses that wouldn't be deductible in the current year or the following year under the accrual basis and special rules apply with respect to mandatory inventory adjustments.

Unless the discussion below refers to one of the methods in particular, the points in this bulletin are applicable to both cash basis and accrual basis farm corporations.

Advantages of incorporation

Limited liability

Unlike a sole proprietor who is fully liable for the debts of the business, a shareholder is not responsible for debts or other liabilities incurred by the corporation. Of course, a shareholder who personally guarantees corporate debts is liable up to the amount guaranteed, and directors and officers can, in certain circumstances, be held liable for activities of the corporation. In general, however, your personal assets are protected from creditor claims and any lawsuits or other liabilities arising in the corporation.

Deferral

Generally, earning business income through a corporation, and paying it out as a dividend to an individual who is taxed at the top rate will not produce a substantial benefit or cost in most jurisdictions. However, once business earnings as a proprietor have reached the top personal tax rates, earnings in a company are initially taxed at a lower rate of tax than if they were earned personally. If the business earns funds that are surplus to the needs of you and your family, then the excess can be retained in the company and the advantage of a tax deferral can be achieved.

There are two levels of tax deferral on business income earned in a Canadian controlled private corporation (CCPCs), — income taxed at the general corporate tax rate and income taxed at the small business tax rate. As the small business tax rate is lower, it creates a larger deferral. The rules regarding when the small business rate is applicable are discussed below under Small Business Deduction.

Under the current tax rules, there are two types of dividends — eligible dividends and ineligible dividends. Where general rate corporate income is received by an individual as an eligible dividend, that dividend is grossed up to reflect the pre-tax income earned by the corporation and a dividend tax credit is allowed. The dividend tax credit reflects the tax paid by the corporation on the income. Where a corporation earns income eligible for the small business rate, the after-tax income is usually paid out as an ineligible dividend. Ineligible dividends are subject to a lower gross-up and tax credit to reflect the fact that qualifying small business income is subject to a lower corporate tax rate. This means that ineligible dividends are taxed at a higher personal tax rate when compared with eligible dividends.

The chart on page 13 shows the 2018 tax rates associated with earning active business income in a corporation taxed at the general business rate or taxed at the small business rate. The chart shows the deferral for both general rate and small business rate income in each province or territory. It also shows the top personal tax rate that would apply to salaries or bonuses earned in each province or territory, and the total tax cost associated with earning business income in a corporation and paying it out to individuals resident in that province or territory as an eligible or ineligible dividend.

The difference in the tax cost of earning business income directly vs. earning this income through a corporation and paying it out as a dividend is relatively small in many provinces/territories when compared with the potential tax deferral.

Where the integration cost is high in a jurisdiction — that is the combined personal and corporate tax cost is high compared to the highest personal tax rate — consideration should be given to whether the integration cost will offset the deferral advantage. In such situations, it is common for owner-managers to pay bonuses to reduce the amount of income taxed in the corporation, and correspondingly increase the amount of income taxed in their hands personally.

Small Business Deduction

The small business deduction reduces the corporate tax rate for qualifying businesses and therefore creates a greater deferral of tax than business income taxed at the general corporate tax rate. The small business deduction reduces both federal and provincial taxes. It is available to CCPCs on their active business income up to a set threshold — the small business limit. The small business limit is currently $500,000 federally and in all provinces and territories except for Manitoba (where it is $450,000, but scheduled to increase to $500,000 as of January 1, 2019) and Saskatchewan (where the

limit is $600,000). The combined corporate tax rate on income up to the small business limit is less than 17.5% in all jurisdictions — much lower than the general corporate tax rates (see chart on page 13).

A CCPC is a Canadian corporation that is not controlled by public corporations, non-residents, corporations with a class of shares listed on a designated stock exchange, or any combination of these. If you are a Canadian resident and you incorporate your business federally or provincially, the company will be a CCPC. Note that an election can be made for a corporation to not be a CCPC which is relevant for the eligible dividend rules. If this election is made, business income earned in the corporation will not be eligible for the small business deduction. However, the election will only apply to change the CCPC status of the corporation for certain tax rules — not all rules.

The small business deduction - restrictions

Certain restrictions apply to limit access to the small business deduction and recent changes to the tax rules have significantly expanded these restrictions.

Association rule - Associated corporations must share the small business limit — that is, corporations that are under common control and ownership. Therefore, if you hold businesses in separate corporations, your corporate group will only be entitled to the low tax rate on the total income of the group up to the small business limit.

Denial rules - Other restrictive rules for accessing the small business deduction were implemented effective for tax years beginning after March 21, 2016. These rules will apply to deny the small business deduction in certain circumstances where a CCPC earns income from the provision of property or services to a private corporation (that is generally not associated) or to a partnership where certain non-arm's length relationships exist (in either case). Where specific conditions are met, the small business deduction will only be allowed if a business limit assignment can be made to the corporation that would otherwise be subject to the denial. Note as well that the assignor's business limit will be reduced accordingly. The rules are extremely complex.

Taxable capital reduction - For large CCPCs, the small business deduction may be reduced. The reduction is based on the corporation's taxable capital in Canada. If a corporation's taxable capital in Canada exceeds $10 million, the corporation is subject to at least a partial reduction of their small business limit in the following year. Once taxable capital in Canada exceeds $15 million, access to the small business deduction is eliminated. In addition, the $10 million and $15 million thresholds must be shared among a group of associated corporations.

NEW ***Passive income rules -*** Starting in 2019, there will be another restriction to using the small business deduction for certain corporations. Because of changes introduced in the 2018 federal budget, CCPCs earning investment income over a $50,000 threshold in the previous year will generally be subject to a reduction of the amount of small business deduction that can be claimed in the current year. Under the new rules, the small business limit will be reduced by $5 for every $1 of investment income above the $50,000 threshold. Under this formula, the small business deduction will be eliminated when investment income reaches $150,000 in a given taxation year. Note that the investment income of all associated corporations in a group must be considered in determining whether these thresholds are met.

For purposes of applying these new passive income rules, there is a new definition of investment income — referred to as adjusted aggregate investment income (AAII). This definition generally includes the following types of investment income: interest, taxable capital gains in excess of allowable capital losses of the current taxation year from the disposition of passive investments, rents, royalties, portfolio dividends, and dividends from foreign corporations that are not foreign affiliates. Also included in the definition of AAII is income from savings in a life insurance policy that is not an exempt policy. Specifically excluded from AAII are gains or losses from the disposition of "active assets" such as from the disposition of shares of a company that is carrying on an active business. Dividends received from connected corporations will be excluded from this new definition, as will income from AgriInvest and rents

or interest received from an associated business if such income is re-classified for income tax purposes to be active business income. In addition, where the activity of earning income from property is sufficient, it will be excluded from AAII on the basis that it is income from an active business and not investment income. For example, if more than five full-time employees were engaged in earning rental income, that rental income would be active business income, and it would therefore not be AAII.

The passive income rules will operate alongside the existing reduction that applies in respect of taxable capital in excess of $10 million. The reduction in the small business limit will be the greater of the reduction under these new rules and the existing reduction based on taxable capital.

Tax benefits from corporate bonuses

For farm corporations filing under the accrual method, by choosing an appropriate year-end, a bonus declared by the corporation can be deducted in its current fiscal year, but not taxed to you until the following calendar year.

Even if there is no need to bonus out income, having the corporation pay a bonus or a regular salary to you will provide you with earned income to allow you to make an RRSP contribution in the following year, and for Canada/Québec Pension Plan contributions in the current year (if this is desirable).

When bonusing out corporate income, a short deferral is available for companies using the accrual basis of accounting. (For companies operating on a cash basis, this planning is not applicable). A bonus is deductible to the corporation in the year it is accrued if it is paid within 180 days of the corporation's year-end. If the corporation's year-end falls within the last half of the calendar year (i.e. July 5 or later), the bonus could be paid to you in the following calendar year. Salary withholdings for income tax, Canada Pension Plan (CPP) premiums and Employment Insurance (EI) premiums (where applicable) would need to be made shortly after the payment of the bonus, depending on the corporation's remittance schedule, but the income tax would have been deferred for up to six months.

Note that EI is generally not payable on remuneration paid to family members (including you). For companies operating on a cash basis, any bonus would have to be actually paid before the end of the fiscal year to be deductible in that year and consequently, this deferral would not be available.

Employee benefits

As a corporate employer must pay tax on earnings distributed to you as a dividend, advantages can arise where the corporation can use these funds to provide you with benefits more efficiently from a tax perspective. In other words, if the provision of a benefit is deductible to the corporation and is not taxable to you personally in whole or in part, the tax treatment may be beneficial. Some common employment benefits that allow for a preferential tax treatment include:

An automobile lease

Whether it is more advantageous from a tax perspective to have your corporation lease a vehicle compared to doing so personally will depend on the facts and circumstances of your situation. However, there may be situations where it is beneficial for a company to lease an automobile that is also used for personal travel. The corporation can deduct the lease payments up to certain limits, but only two-thirds of the amount is treated as a taxable benefit to you.

Corporate-owned automobiles, however, are not for everyone. For more information, see our bulletin *Automobile Expenses and Recordkeeping*. Note that the Canada Revenue Agency (CRA) has said that employment benefits can arise for other vehicles that do not meet the definition of an automobile when used personally — consult with your BDO advisor.

Health care premiums

Premiums paid by the corporation to a private health insurance plan for you will be deductible to the corporation and will not be a taxable benefit to you, if certain conditions are met. This effectively means that these premiums can be paid out of pre-tax corporate profits, rather than with personal funds. To qualify for this special treatment, you must have received this benefit by virtue of your

employment and not by virtue of your shareholdings. When applying this test, the CRA may conclude that you received the benefit as a shareholder if similar coverage was not extended to other full-time employees who are not shareholders. For Québec tax purposes, employer contributions to a private health plan are deductible to the corporation (if contributions are by virtue of employment rather than shareholdings). However, they are generally considered a taxable benefit to the employee.

Individual pension plan

Rather than contributing to an RRSP, another retirement savings option is available to owners of incorporated businesses. Under the rules for defined benefit pension plans, it is possible to set up an individual pension plan (IPP) for business owners. Under an IPP, the benefits are set by reference to your salary, and contributions are made to build sufficient capital to fund a defined pension benefit. For eligible individuals, the use of an IPP can allow for greater contributions (which generally grows with age) when compared to an RRSP. Over time, the use of an IPP can produce substantial tax advantages over an RRSP. Additional benefits of an IPP include the ability to make up for poor investment performance and the possibility of higher retirement benefits.

Estate freeze

On death, you're deemed to dispose of all of your capital assets (for instance, your business assets) at their fair market value. If the assets have increased in value, this will cause capital gains and possibly a recapture of previously claimed depreciation. The resulting taxes could be so high that your executor may have to sell off the business to pay the liability. Although it's possible to transfer assets at tax cost to your spouse on death, your spouse will face the same issue on the eventual transfer to your children. Therefore, it's wise to take steps to minimize the tax arising on death. This type of planning is referred to as estate planning. (For purposes of this bulletin, “spouse” also refers to a common-law partner).

In the case of farm assets, it is important to note that there is an exception to this deemed disposition rule with respect to capital property used in your farming business, such as land, buildings, equipment and quota which can be transferred to your children at cost. This means that no capital gains will be realized until your children sell the property. There is also the ability to use the remaining capital gains exemption on death.

You may have heard of the concept of an estate freeze. For non-farm family businesses where assets are held through a corporation, this common estate planning technique is a method of capping or "freezing" the value of the assets, while allowing future growth to accrue to other family members.

In an estate freeze, business assets are transferred to a new corporation in exchange for preferred shares. A special election form will be required to avoid realizing capital gains or income on the transfer. The shares received should have a value equal to the value of the assets transferred and be structured to meet your particular requirements so all future increases in value of the corporation's assets will accrue to the common shares. The common shares can then be issued to other family members for a nominal amount.

The result is that your business is frozen at its value at the time of the freeze. Your maximum tax liability on death can be determined and provided for. Any increase in value that arises after the freeze will only be subject to tax when the common shareholders, your children for example, sell their shares or when they die.

You can carry out an estate freeze at the time you incorporate your business. However, you should be careful not to freeze your business too early in life — you may require greater funds for retirement or your intentions as to who should benefit from the freeze or who will succeed you in the business may change. Note that a family trust can be used to hold the common shares of the company until it is decided who will receive the common shares at some time in the future.

At a minimum, you should ensure the share structure you set up for the corporation will allow for a future estate freeze.

For shares of an FFC, an estate freeze is not necessary for income tax purposes as shares of an FFC can be passed on during your lifetime to your

children at cost provided that any proceeds received for the shares do not exceed their cost. However, based on our experience, you may want to do an estate freeze for non-tax reasons so that when your children take over the farm operations, they will have a sense of ownership and the future growth from their efforts will accrue to the common shares they hold. Consequently, an estate freeze can still be a useful tool from the perspective of succession planning.

If you have shares of an FFC, you can transfer these shares to your children without undergoing a freeze. As well, on your death, shares of an FFC can be transferred to your children at cost or at a value elected to use your capital gains exemption. Therefore, even if no freeze has been done, you will still be able to avoid tax upon your death on the value of the shares. Your children will also be able to transfer the shares to their children using the same provisions so the tax deferral would continue into the future. Consult your BDO tax advisor for further details.

If you do carry out an estate freeze, there are a number of pitfalls you must be careful to avoid. For instance, when you transfer assets to a corporation of which your spouse or minor children are shareholders, there could be an imputed interest penalty to you under the corporate attribution rules. This problem can be avoided if your spouse is not a shareholder. For minor children, a trust can be used and the trust agreement can state that the child is not entitled to income or capital until they reach age 18. This particular problem can also be avoided if the corporation is an SBC (see below).

Income splitting

Income splitting is the process of redirecting income within a family group to take advantage of the lower tax brackets, deductions and credits available to each family member.

In running your own farm business, there are a number of possibilities for income splitting. Many of these apply whether or not the business is incorporated. For instance, you could pay your spouse or children reasonable salaries for work performed in the business. On the other hand, you could pay your spouse a guarantee fee if he or she has pledged assets or otherwise guaranteed the debts of the business. If your business is incorporated, other possibilities arise, such as paying your spouse a director's fee for services performed in that capacity.

For a number of years, our tax rules have severely restricted income splitting with minor children by applying a special high rate of personal tax to certain types of income — such as dividends received from a private corporation. These rules are the “tax on split income” or “TOSI” rules (which were often referred to as the “kiddie tax rules”). Beginning on January 1, 2018, the TOSI rules have been expanded by the federal government. They now apply to certain adult family members (as well as minor children) and additional types of income. The changes specifically target private corporations and have significantly reduced opportunities to income split by way of dividends with family members who are not active participants in the business of the corporation. The expansion of the rules has a very broad impact and has made the rules quite complex. This bulletin will not explore all of the TOSI rules in detail. Consult with your BDO tax advisor on how these expanded rules will affect any planned changes to your business structure as a result of incorporation (or their impact on your current business structure that involves a corporation, trust and/or partnership).

The estate planning structure discussed above would have allowed for income splitting previously if your spouse or adult children had subscribed for shares in your corporation (in a tax-efficient manner) and were paid dividends. However, under these new TOSI rules, using corporate shares to pay dividends to family members (including your spouse) who do not participate in the business in a significant way will be costly. Unless an exclusion from the new TOSI rules applies, such dividends will be taxed at the top personal tax rate, negating any benefit of income splitting with dividends.

However, if the shares of the corporation could qualify for the capital gains exemption at some point in the future, there could still be a tax benefit to be achieved from allowing your spouse or children to own shares in your corporation

(either directly or through a trust). Please see the discussion under “Advantages of an SBC and an FCC”.

As an owner-manager of your corporation, using dividends to income split with your spouse who does not hold a sufficient interest in the business or who is not sufficiently involved in the business will be caught by the new TOSI rules. However, once you reach the age of 65, such income splitting may be available as an exclusion will generally apply so that income that would be considered split income in your spouse’s hands (for example, dividends from your corporation) will not be subject to TOSI if that same income would not be subject to TOSI in your hands.

Scientific Research & Experimental Development (SR&ED) Incentives

For those farmers who are not incorporated and who are carrying out scientific research and experimental development, incorporation may benefit the business as a corporation can access greater tax benefits from carrying on SR&ED than an unincorporated business. A qualifying CCPC may benefit from a federal investment tax credit (ITC) of 35% (plus any applicable provincial ITC) on SR&ED expenditures up to $3 million in the year when compared to 15% for a proprietorship or non-corporate partnership. The enhanced ITCs earned by a CCPC may also be refunded in cash at a higher rate. While the cash refund for proprietorships and non-corporate partnerships is generally limited to 40% of the unused ITC generated in the year, a qualifying CCPC can claim a cash refund of 100% of the enhanced ITCs earned in the year. This means that refunds of up to $1.05 million (i.e. 35% of the $3 million annual SR&ED expenditure limit) may be available to qualifying CCPCs each year.

A CCPC’s eligibility for the enhanced 35% ITC rate and related cash refund depends on whether its taxable income for the previous year, aggregated with the taxable incomes of any associated corporations, is below $500,000. If the taxable income of your associated group for the previous year is more than $500,000, the annual amount of SR&ED expenditures eligible for the enhanced 35% ITC is effectively reduced and eliminated at an income level of $800,000. Similarly, the expenditure limit is also reduced if the associated corporations’ taxable capital employed in Canada in its previous year exceeds $10 million and is eliminated when it reaches $50 million.

Advantages of an SBC and an FFC

Thus far, we've presented tax planning ideas which apply to all CCPCs. If a corporation is an SBC or an FFC, there are further advantages.

What is an SBC?

A corporation qualifies as an SBC if:

- It's a CCPC; and
- All or substantially all of its assets are used in an active business (which includes farming) carried on primarily in Canada. The CRA interprets this to mean that assets representing at least 90% of the fair market value of all assets are used for business purposes.

A CCPC holding only shares or debts of other companies may qualify, provided those other companies are also SBCs.

Some corporations reinvest all of their profits back into the business, so meeting the asset use test does not pose a problem. Other corporations invest surplus funds in investments which are not required for business purposes. If the fair market value of these investments exceeds 10% of the fair market value of all assets, the corporation will not be an SBC. You can ensure that your corporation continues to qualify by reinvesting any excess funds in business assets or by removing them from the corporation, through payment of dividends, salary or repayment of shareholder loans.

Note the word "small" in the definition of a "small business corporation" is a misnomer. There are no size restrictions for being an SBC.

What is an FFC?

Farm corporations may qualify as both an SBC and an FFC. A corporation qualifies as an FFC if all or substantially all of the value of the assets in the corporation are attributable to property that was principally used in a farm business in Canada that a family member was actively engaged in. The CRA interprets this to mean that assets representing at least 90% of the fair market value of all assets are used for purposes of the farming business.

It's often easy to run afoul of both the SBC rules and the FFC rules. For example, if there has been a build-up of assets in the corporation that are not used in the farm business, the "all or substantially all" test may not be met at the time the ownership of the shares is transferred, meaning that the gain will not qualify for the capital gains exemption as an FFC. Details on the use of the capital gains exemption on the sale of shares of an FFC are discussed further below, as there are additional requirements to fulfill.

Capital gains exemption

If you sell the business in the future or pass it on to your children at death, you can make use of the capital gains exemption.

The capital gains exemption is indexed for inflation for taxation years after 2014. The exemption for 2018 is $848,252. Note that the exemption was increased to $1 million on dispositions of qualified farm or fishing property on or after April 21, 2015. These exemptions are only available to individuals and not corporations.

A note of caution — careful planning is required in order to take advantage of the capital gains exemption. The tax rules that must be complied with are complex. For example, for an asset to qualify for the capital gains exemption, there are important tests that must be met. It's also important to get good tax advice if you own property that has been farmed by family members in the past. Even if a family member is not currently farming it, it may still be considered to be qualifying farm property and therefore any gains would be eligible for the capital gains exemption when it is sold. It's important to work closely with your BDO advisor to ensure that you will benefit from the exemption where appropriate.

Qualifying shares of an SBC

To use the capital gains exemption on the sale of shares of an SBC, you must meet the following conditions:

- The corporation must be an SBC at the time of the sale.
- More than 50% of the corporation's assets (on the basis of fair market value) must have been used in an active business carried on primarily in Canada throughout the 24-month period immediately before the sale.
- The shares must not have been owned by anyone other than you or someone related to you during the 24-month period immediately before the sale.

For more information on the sale of qualifying shares of an SBC, see our tax bulletin *Incorporating Your Business*.

Qualifying farm property

Qualifying farm property includes real property, farm quota, as well as shares in a family farm corporation or an interest in an FFC, but does not include machinery and equipment, livestock, or crops. It is important to note that you do not have to incorporate your farm in order to claim the capital gains exemption as real property, farm quota, and certain other property used for farming can be disposed of through an asset sale and qualify for the capital gains exemption.

Claiming the exemption on farm property when incorporating

Owner-managers of non-farm businesses can only claim the capital gains exemption where the corporation is a small business corporation that meets certain requirements (as outlined above) and they sell the shares. Farm business owners, on the other hand, have a lot more flexibility in claiming the capital gains exemption and unlike the rules that exist for the shares of an SBC, farm owners can convert the capital gains exemption into cash due to the ability to claim the capital gains exemption on property other than shares. This is important as most farm business sales are structured as a sale of business assets and not shares.

The exemption, available only to individuals, basically ensures that you do not pay tax on the first $1 million of capital gains arising from the disposition of qualifying farm property. If a farming property or quota is transferred to a corporation and then it increases in value, a capital gains exemption cannot be claimed if these assets are sold by the corporation. However, if these assets already have an accrued gain, it is possible to use your capital gains exemption by transferring these

assets to the corporation to trigger a gain eligible for the capital gains exemption or to transfer the assets to the corporation using a rollover election and electing to receive proceeds equal to an amount large enough to trigger a gain equal to your remaining capital gains exemption. This will create the ability to take cash out of the company on a tax-free basis or take back corporate debt up to the amount of the elected transfer price. The amount of cash that can be withdrawn is equal to the proceeds for capital gains purposes. Therefore, if the corporation later sells the asset, the capital gains exemption has been effectively locked into the corporation's cost of the asset and you will be able to receive part of the proceeds as repayment of the debt. Or you can pay out after-tax small business income to yourself prior to the sale of the asset in question as a debt repayment.

There are downsides to this type of planning as well — in certain circumstances, it is advisable to maintain ownership of real estate and quota personally, where possible, and only transfer farm inventory and equipment to the corporation. The real estate and quota can then be leased to the company. When the farm is sold and the corporation sells its business assets, the assets held personally can be sold at the same time and the capital gains exemption can be used to exempt the capital gains on the assets that were held personally. Note that many marketing boards have rules regarding incorporation and they may not allow the quota to be kept outside the corporation. However, some will allow the quota to be held outside the corporation if certain conditions are fulfilled.

As a final note, a Tax Court case has suggested that the general anti-avoidance rule can apply where the capital gains exemption is used to realize cash from a corporation. Contact your BDO advisor for more information.

Claiming the exemption on a share sale

You can also claim the capital gains exemption against the gain from your FFC shares, but it's important that you structure the sale of your farm as a sale of shares of the company and not as a sale of the farming property that is owned by the company. On the sale of FFC shares, you may be able to claim your capital gains exemption as long as "all or substantially all" of the assets in the corporation were used principally in the farm business. Note that if this test is not met, it may be possible to remove the redundant assets from the corporation prior to a sale to ensure that the shares are qualifying property. As well, throughout any 24-month period ending before the disposition, greater than 50% of the fair market value of the assets of the corporation must have been used principally in the farm business in which a qualified user was active.

Keep in mind, however, that the purchaser of your farm will likely prefer to purchase your farming property directly from the company, rather than purchasing the shares of your family farm corporation. This is due to the fact that the amount that they pay for your shares will be reflected in the tax cost of their shares, which will only be of benefit to them when they dispose of them. However, if they buy the assets directly, the amount they pay will be reflected in the tax cost of the individual assets they have purchased which they may be able to write-off for tax purposes as they run the farming business. Therefore, the purchaser may ask for a price discount if you insist on selling the shares. Keeping quota and real property in your hands personally (where possible) will help minimize this problem.

Note that these difficulties can often be overcome if the main asset of the farm is non-depreciable land. Through careful tax planning, the purchaser can usually purchase shares and then reorganize their affairs to transfer the amount that they paid for the shares to the tax cost of the underlying land held in the corporation.

As noted earlier, each Canadian resident individual is entitled to one lifetime capital gains exemption that can be claimed against capital gains realized on transfers of ownership of qualifying farm property (or qualified small business corporation shares). It makes sense that if you, your spouse and your children realized capital gains on the sale of your farm and each claim the capital gains exemption, your family's overall tax bill on the sale of your farm can be significantly reduced.

What steps can you take to ensure that all family members can take advantage of their capital gains exemption? This can only be accomplished if you

properly plan as you approach retirement. Refer to our bulletin *Tax Planning for Canadian Farmers* for examples where it may be possible to maximize your family's exemption claims by transferring ownership of farming property to your spouse or to your children.

Talk to your BDO advisor before making any decisions to sell your farm business.

Some points about the capital gains exemption

If you plan to realize capital gains on your farming property and claim your lifetime capital gains exemption, there are some additional issues that you need to discuss with your BDO advisor. Even though no income tax has to be paid on a capital gain when the exemption is claimed, there can be other negative consequences. These include:

- **Old Age Security (OAS)** — A taxable capital gain (even one against which the exemption is claimed) will increase your net income for tax purposes. If you are 65 or older and receiving OAS, the benefits you receive will be reduced when your net income exceeds $75,910 (for 2018). Full OAS benefits will be completely eliminated when net income exceeds approximately $123,000. Similar problems can arise for recipients of guaranteed income supplements.
- **Age Credit** — Similarly, the age tax credit, available to you when you are 65 or older, is reduced by 15% of your net income in excess of approximately $37,000 (varies by province).
- **Alternative Minimum Tax (AMT)** — A large capital gain may trigger an AMT liability on your tax return. Although this tax will be refundable in future years when regular income tax exceeds AMT, this can cause you cash flow problems when you have to pay this tax for the year in which the capital gain is triggered.
- **Cumulative Net Investment Loss (CNIL)** — You will not be able to claim your capital gains exemption to the extent that you have a CNIL balance. A CNIL is the cumulative total of your investment expenses less your investment income since 1987.
- **Allowable Business Investment Losses (ABILs)** — You may not be able to claim your full capital gains exemption to the extent you have claimed any ABILs in past taxation years.
- **Other Benefits and Credits** — Employment insurance and other benefits will be clawed back when your net income exceeds a certain threshold. For purposes of determining these benefits, taxable capital gains increase your net income, even when the exemption is claimed. The same issue arises when determining whether you are eligible for certain provincial tax credits, as eligibility depends on the level of your net income.

Talk to your BDO advisor before you trigger any capital gains to ensure that you understand the impact that these gains will have on the above.

Estate planning through an SBC

Estate planning is made easier if the corporation is an SBC. As noted previously, if you transfer property or make a low-interest loan to a corporation of which your spouse or minor children (a son, daughter, niece or nephew under 18 years of age) are shareholders, an imputed interest penalty will be included in your income for each year that the loan is outstanding. The penalty is interest at the CRA's prescribed rate on the outstanding amount of the loan or the value of the property transferred to the corporation. It is reduced by any interest received in the year on the loan and by dividends received by you from the corporation in the year. The reduction for dividends is based on the actual dividend received and then "grossed-up". The grossed-up amount is 138% for eligible dividends and 116% for ineligible dividends received in 2018 (115% for ineligible dividends received in 2019).

Depending on the method you choose for an estate freeze, a share transfer may be caught by the corporate attribution rules.

However, the corporate attribution penalty does not apply for any period throughout which the corporation qualifies as an SBC. Therefore, if you ensure that your company always meets the 90% test for business assets, you can carry out an estate freeze without concern for these corporate attribution rules. However, keep in mind that these rules are independent of the new TOSI rules, which

will have their own negative tax consequences for certain shareholders.

Income splitting with your spouse and children

As previously discussed, income splitting with your spouse and adult children has been greatly restricted under the expanded TOSI rules. However, there is still the possibility to split income where that income is taxable capital gains realized on the disposition of property that is qualified farm or fishing property or qualified small business corporation shares, as these gains are specifically excluded from the TOSI rules.

This exclusion will apply for minor children as well, with one exception. Taxable capital gains realized by minors on non-arm's length transfers of certain shares (for example, private company shares) will be re-characterized into taxable dividends. As a result, the capital gains exemption will not be available in these circumstances, as these gains will instead be treated as ineligible dividends that will be subject to TOSI. This rule also applied prior to 2018 to restrict income splitting before the expansion of the TOSI rules.

The exclusion for gains on eligible property will enable families to continue to plan to access the capital gains exemption of each family member on the disposition of the business (where those family members would otherwise be subject to the TOSI rules). As well, for this TOSI exclusion to apply it is only necessary for the property to qualify for the capital gains exemption — the exemption doesn't need to be claimed. This means that none of the taxable capital gains realized on eligible property will be subject to TOSI (with the exception of certain recharacterized gains of minors as noted above).

Where TOSI does not apply, a qualifying taxable capital gain would be taxed at the incremental tax rates that apply to your spouse or children at the time of sale, instead of being taxed at the highest marginal tax rate. Of course, there will be no tax on the portion of eligible capital gains that are covered by the capital gains exemption.

Allowable Business Investment Loss (ABIL)

If your corporation qualifies as an SBC and the business should fail, you may be allowed to deduct an ABIL rather than a capital loss for the loss of your investment in shares or debt of the SBC. An ABIL is calculated in the same manner as an allowable capital loss in that only one-half of the loss is allowed as a deduction. The difference is an ABIL can be claimed as a deduction against other types of income as opposed to a capital loss which can only be applied against capital gains. If you have previously claimed a portion of your capital gains exemption, the ABIL may be converted into an ordinary capital loss to the extent you claimed the exemption.

Disadvantages of incorporation

Of course, there are some disadvantages associated with incorporating, such as increased recordkeeping, corporate tax returns and other government filings. However, they may not represent a significant additional cost if your business is already a sizable concern.

Incorporation also means you are unable to use business losses to offset your personal income. Therefore, it's generally advisable to defer incorporation until the business is profitable, unless there are potentially large business liabilities which could deplete your personal assets.

As discussed earlier in this bulletin, another downside to incorporating your farm business is that corporations do not have a capital gains exemption available to them for the sale of farm assets while an exemption may be available to you personally. Consequently, to benefit from the exemption, you would have to sell the shares of your corporation.

A further disadvantage to incorporating your farm business will occur if your farm residence is also transferred to the corporation. There would be a taxable benefit for the family members who use the corporate-owned residence as well as the loss of the principal residence exemption.

Other considerations

Further tax planning for cash basis farmers

If you are a cash basis farmer, there are some further planning options available to you when incorporating your farm business. For example, you

may have a significant balance of inventory with no tax cost and you may be considering liquidating this inventory and not replacing it. If you incorporate prior to the liquidation, you will have the opportunity to take advantage of the lower corporate tax rates and tax deferral.

Ontario Corporate Minimum Tax

Farm corporations in Ontario will have to consider Ontario corporate minimum tax (CMT). This will be a concern for larger corporations as many large farm corporations have significant net income on their income statement (prepared on an accrual basis) but little, if any, taxable income as a result of cash basis adjustments. Note that for taxation years ending after June 30, 2010, where a corporation (together with any associated corporations) has total assets in excess of $50 million and total revenues in excess of $100 million, it will be subject to Ontario CMT.

Summary

As you can see, there are a number of tax planning opportunities available to you if you carry on business in corporate form and maintain your corporation as an SBC or an FFC. However, there are also some pitfalls to be wary of. Much of the planning discussed in this bulletin will be specific to your individual and corporate circumstances. In addition, many of the tax rules involved in the planning are very complex. Contact your BDO advisor for details on how these tax planning ideas can benefit you.

Comparison of Tax Rates – Tax Deferral and Integration With the Use of a Corporation — 2018

	Corporate/Personal Tax Rates [1]			Potential Deferral		Integration: Effective Tax Rates on Income Taxed in a Corporation [2] — Active Income Earned in a Corporation and Net Income After-tax Paid out as a Dividend	
	Small Business Tax Rate (%)	General Corporate Tax Rate (%)	Top Personal Tax Rate (%)	At Small Business Rate (%)	At General Corporate Rate (%)	At Small Bus. Rate: Ineligible Dividend (%)	At General Corporate Rate: Eligible Dividend (%)
B.C.	12.00	27.00	49.80	37.80	22.80	50.48	51.97
Alta.	12.00	27.00	48.00	36.00	21.00	48.64	50.15
Sask.	12.00	27.00	47.50	35.50	20.50	46.85	48.64
Man.	10.00	27.00	50.40	40.40	23.40	51.33	54.58
Ont.	13.50	26.50	53.53	40.03	27.03	54.02	55.41
Qué.	17.24	26.70	53.31	36.07	26.61	54.34 [3]	55.94 [3]
N.B.	12.62	29.00	53.30	40.68	24.30	53.58	52.79
N.S	13.00	31.00	54.00	41.00	23.00	54.18	59.69
P.E.I.	14.00	31.00	51.37	37.37	20.37	52.06	54.61
N.L.	13.00	30.00	51.30	38.30	21.30	51.11	59.83
Y.T.	12.00	27.00	48.00	36.00	21.00	48.45	48.11
N.W.T.	14.00	26.50	47.05	33.05	20.55	44.94	47.32
Nunavut	14.00	27.00	44.50	30.50	17.50	45.63	51.15

(1) Rates used are average rates for the year and are current to September 1, 2018.

(2) The tax rates for corporate income are the combined corporate and personal tax rates for tax paid by earning business income through a corporation eligible for the small business rate or a corporation taxed at the general corporate rate. Certain provinces, including Saskatchewan, Ontario, Quebec and Yukon provide lower corporate tax rates on income from Manufacturing and Processing (M&P), which are not reflected in the rates above. The rates assume that income taxed in the corporation is then paid out as a dividend and taxed in the shareholders' hands at top personal rates for 2018. In the case of small business income, it is assumed that the dividend received by the individual is ineligible. In the case of general rate income, it is assumed that the dividend is eligible.

(3) The effective tax rate on income taxed in a corporation on ineligible dividends paid before March 28, 2018 was 53.60%. Similarly, the effective tax rate on income taxed in a corporation on eligible dividends paid before March 28, 2018 was 55.90%.

The information in this publication is current as of October 1, 2018.

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