

TAX BULLETIN

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Incorporating Your Farm Business

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, farm corporations 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, which means that they also have to report sales billed for which they haven't yet received cash as income. 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.

Here are some of the advantages of incorporating your business:

- **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.

- **Small Business Deduction**

Active business earnings of a Canadian-controlled private corporation are eligible for special reduced rates of tax at both the federal and provincial levels.

- **Deferral of Tax**

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 deferral of tax can be achieved.

- **Tax deferral on 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.

- **Employee benefits**

As an employee of your corporation, you can receive employment benefits that are deductible to the corporation and eligible for special tax treatment in your hands.

- **Estate planning**

By setting up an appropriate share structure, you can hold and control the corporation while any increase in value accrues to shares held by your children. This can help minimize any tax liability

arising on your death. As well, there are special rules that pertain to farm property.

- **Income splitting**

Your spouse and adult children may be able to subscribe for shares of the corporation and receive dividends from the profits of the business. In the case of your spouse, however, you'll need to ensure you don't run afoul of the corporate attribution rules.

Due to the income-splitting tax (often referred to as the kiddie tax), the benefits of splitting dividends are eliminated for minor children. As well, in the 2011 federal budget, a proposal was announced to further extend the kiddie tax to apply to capital gains of shares in privately companies held by minors. For more information on these limitations, see "Income splitting with your spouse and children" on page 11.

The above benefits apply to all corporations that carry on business. If your corporation qualifies as an SBC, additional benefits are available:

- **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 \$750,000 capital gains exemption. You can even lock in this benefit now, by stepping up your shares' tax cost. (Note that the capital gains exemption is also available on shares of an FFC.)

- **Income splitting**

If a corporation is an SBC, your spouse can be a shareholder and receive dividends, without concern for the corporate attribution rules.

- **Allowable business investment loss (ABIL) treatment**

If your SBC should fail, the loss of your investment in shares or debt may qualify as a business investment loss, one-half of which would be allowable as a deduction against income from all sources, not just against capital gains.

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.

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. So, to benefit from the exemption, you would have to sell the shares of your corporation. This will be discussed in further detail later in the bulletin. 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 residence as well as the loss of the principal residence exemption.

The remainder of this bulletin provides more details on the advantages of incorporation and of maintaining your company as an SBC or an FFC.

Advantages of incorporation

The Small Business Deduction

One of the major reasons a business incorporates is to obtain the benefit of the Small Business Deduction. This is a reduction in both federal and provincial tax that is available to Canadian-controlled private corporations (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 except Manitoba and Nova Scotia, where it is \$400,000. The corporate tax rate on income up to the federal small business limit is 19% or less in all jurisdictions – much lower than the general corporate rates (see chart on page 13). This low corporation tax rate ensures that there are more after-tax dollars in the corporation to reinvest in the farming business.

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.

The small business limit must be shared by associated corporations – that is, corporations which 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 total income up to the small business limit.

It should be noted that for large CCPCs, the Small Business Deduction will be reduced. The reduction is based on the corporation's taxable capital in Canada as determined for purposes of the Large Corporations Tax (LCT) for the prior taxation year. Although the LCT was eliminated in 2006 the rules are still relevant for several tax calculations including this reduction to the Small Business Deduction. If a corporation's taxable capital in Canada exceeds \$10 million, the corporation is subject to at least a partial reduction in the small business limit in the following year. Once taxable capital in Canada exceeds \$15 million, the corporation is subject to a full reduction. In addition, the \$10 million and \$15 million thresholds must be shared among a group of associated corporations. With this rule, large farm businesses may not qualify for the Small Business Deduction.

There are two benefits to claiming the Small Business Deduction:

1. Tax savings

As a rule, earning small business income through a corporation, and paying it out as a dividend to an individual who is taxed at the top rate will generally not produce a substantial benefit or cost in most provinces. However, tax savings can be achieved where after-tax small business income is paid to a low income family member as a dividend.

For income where tax is paid at the general corporate income tax rate, it should be noted that our tax rules were changed extensively for the 2006 and subsequent taxation years to eliminate (or significantly reduce) the tax cost associated with earning income subject to the general tax rate in a corporation and paying it

out to individuals as a dividend. Under the current tax rules, there are two types of dividends – eligible dividends and ineligible dividends.

Eligible dividends are basically dividends that are paid out of after-tax business income that was taxed at the general corporate rate without the benefit of a Small Business Deduction. This income may have been business income earned directly by the corporation paying the dividend or may be business income that was received from another corporation as an eligible dividend. 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, which reflects the tax paid by the corporation on the income. All provinces and territories have followed the changes made by the federal government.

Where a corporation earns income eligible for the small business rate, the after-tax income is generally paid out as an ineligible dividend. Ineligible dividends are subject to a lower gross-up and tax credit to reflect the fact that small business income is subject to a lower corporate tax rate. This means that ineligible dividends are taxed at a higher tax rate when compared with eligible dividends.

Tracking income that can be paid as an eligible vs. an ineligible dividend can be complicated, and any decision on paying dividends should be made in conjunction with your BDO advisor.

2. Tax deferral

The above comments assume the after-tax corporate earnings are immediately paid out as a dividend. If, instead, the funds are left in the corporation, the personal tax on the dividend is deferred. The lower corporate tax rate leaves greater after-tax dollars in the corporation to pay expenses and reinvest in assets.

Before the changes in the taxation of dividends, if the corporation's active business income exceeded the small business limit, many corporations paid the excess to the owner(s) as a bonus. The bonus would be deductible to the corporation and taxable in the owner's hands. In

the past, the combined corporate and personal tax on income in excess of the annual limit could greatly exceed the personal tax payable on the bonus.

However, with the eligible dividend rules, it may no longer be necessary to bonus out this income. As shown on the chart on page 13, the difference in the tax cost of earning general rate business income directly vs. earning this income through a corporation and paying it out as an eligible dividend is relatively small in most provinces/territories when compared with the potential tax deferral.

In our current tax environment, owner-manager remuneration strategies are being further complicated by changing tax rates. Specifically, there will be further reductions in the federal corporate tax rate until 2012 while the personal tax rate on eligible dividends will be increased. The personal tax rate on dividends will increase between 2011 and 2012, at which point federal rates are projected to remain at the 2012 rate. This means that for 2011, integration will work best where the dividend is paid in the same year or the time-frame is long enough that the deferral advantage makes up for the higher overall tax cost.

So while in the past the general rule of thumb was to have the corporation pay an owner-manager a salary or bonus to reduce its income to the small business limit (as the total corporate and personal tax associated with retaining the excess income and paying it out as a dividend exceeded the tax cost of a bonus) this may no longer be the best option. In fact in recent years, beneficial tax reductions have made this rule of thumb more difficult to apply. Given that there are a number of considerations to make when determining whether to retain income in your corporation or pay a bonus, you should discuss this decision with your BDO advisor.

If your corporation earns investment income, there is another consideration to make. With the corporate tax rate reductions being implemented and the eligible dividend rules, it may be wise to consider mixing investment earnings in a holding company with eligible dividends received from

the operating company. This can enhance the deferral benefit as the investment income is subject to a refundable tax, which is refunded on the payment of a dividend. If the dividend refund can be triggered by flowing an eligible dividend from the operating company through the holding company to shareholders, this could result in a significant tax deferral on the investment income earned by the holding company. Ideally, the cash paid out as an eligible dividend will be just large enough to cover personal costs and to trigger a full refund of the refundable tax.

Your BDO advisor can help you decide whether you should allow income to be taxed in your corporation or whether you should pay out the income in excess of the small business deduction as a bonus.

Tax benefits from corporate bonuses

Even if there is no need to bonus out general rate income with the eligible dividend taxation rules, having the corporation pay a bonus or a regular salary to you will provide you with earned income for 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 deferral is available for accrual basis taxpayers. 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 6th or later), the bonus could be paid to you in the following 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 payment of the bonus, depending on the corporation's remittance schedule, but the income tax would have been deferred for 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.

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**

This is especially advantageous where a leased automobile is primarily for personal use. 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 not a taxable benefit to you, provided that certain conditions are met. 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. It should be noted that these premiums are not deductible for Québec tax purposes.

- **Automobile allowance**

As an employee, you may receive a tax-free automobile allowance if you use your own automobile when performing your duties. The CRA normally considers the allowance reasonable

if it does not exceed the rates it sets annually. For 2011, the rate is 52 cents/km for the first 5,000 km of business travel, and 46 cents/km for business travel over 5,000 km. The rates are each 4 cents higher for kilometers driven in the Yukon, Northwest Territories and Nunavut. The allowance is beneficial because you only have to track the distance travelled on business.

- **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 or IPP for business owners. Under an IPP, the benefits are set by reference to your salary, and contributions are made to build sufficient funds to fund this defined pension benefit. For many individuals (generally, in their 50s or older), the use of an IPP can allow for greater contributions when compared to an RRSP. Additional benefits of an IPP include the ability to make up for poor investment performance and the possibility of making lump-sum contributions for past service.

Changes announced in the 2011 federal budget have significantly changed the viability of IPP's and have left many wondering if they are still an advantageous retirement savings vehicle. For more information on these changes and a discussion of their impact on IPP's see the article "Individual Pension Plans - Do They Still Make Sense?" in the 2011-02 edition of the *Tax Factor*.

- **Retiring allowances**

When you or another family member retire from the corporation, either on a sale to third parties or a transfer to your children, the corporation could pay a retiring allowance eligible for a rollover to an RRSP. For newly incorporated farm businesses, a rollover to an RRSP will not be allowed for amounts paid to the former proprietor, as the rollover is only applicable to years of service as an employee prior to 1996. The CRA has established guidelines as to what constitutes a reasonable amount. The amount paid, as long as it is reasonable, will be a deduction against farming income for tax purposes, which could be particularly useful as

you wind-up farming operations and the income arising on the sale of the inventory and capital assets has to be reported for tax purposes.

The retiring allowance will be employment income to the recipient which they can transfer to their RRSP, within certain limits for years of service as an employee prior to 1996. If it is transferred to an RRSP, the amount will not be taxable until the amounts are withdrawn from the RRSP, which could be several years in the future.

Estate freeze

On death, you're deemed to dispose of all 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.

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 estate is frozen at its value at the time of the freeze. Your maximum tax liability on death can be determined and provided for. Any increases 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.

For shares of a family farm corporation, 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 a family farm corporation, you can transfer these shares to your children without undergoing a freeze. As well, on your death, shares of a family farm corporation can be transferred to your children, either directly or through a spousal trust, 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 at 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.

There are a number of pitfalls in carrying out an estate freeze which 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, the trust agreement can state that the child is not entitled to income or capital until they reach age 18. The problem can also be avoided if the corporation is an SBC (see below).

Income splitting

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. Or, 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.

The estate planning structure discussed above also allows for income splitting. For instance, your spouse and adult children could subscribe for shares in your corporation and be paid dividends. Or, you can gift shares to adult children (but not a spouse). The advantage here is the ability to have the dividends taxed in the hands of more than one person, which generally means that the overall tax on the dividends is lower. With the use of more than one class of shares, it would be possible to pay the dividends to selected individuals or a group of individuals.

You should ensure that family members pay fair market value for any shares issued to them (other than when shares are gifted to an adult child). This should not be a problem if you have just done an estate freeze, since the common shares will generally have only a nominal value. Also, family members must acquire the shares with their own funds where consideration is paid. If you provide the funds to an adult child as a loan or to a spouse as either a gift or a loan, any dividends they receive would be taxed in your hands.

If you've transferred property or made low-interest loans to the corporation, there could be problems with the corporate attribution rules.

Income splitting is made simpler if the corporation qualifies as an SBC (subject to the income splitting tax). This is discussed further below.

With the income splitting tax that applies to certain income received by minor children, most benefits from splitting income with a minor child have disappeared. See "Income splitting with your spouse and children" on page 11.

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 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 or partnership interest are 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 a family farm corporation are discussed further below as there are additional requirements to fulfill.

Capital gains exemption

From 1985 to 1994, Canadian residents were able to claim a special deduction to reduce or eliminate tax on up to \$100,000 of capital gains. If the gain arose on the sale of shares of an SBC or on the sale of qualifying farm property, an additional \$400,000 was often available. Although the 1994 federal budget eliminated the general \$100,000 exemption for dispositions after February 22, 1994, the \$500,000 exemption remained and could be claimed to reduce capital gains from qualifying shares of an SBC, qualifying farm property and beginning in 2006, fishing property. This exemption is only available to individuals and not corporations.

The capital gains exemption was increased to \$750,000 for dispositions after March 18, 2007. The increased exemption is available on qualified shares of an SBC, qualified farm property and qualified fishing property.

A note of caution - to take advantage of any of the above exemptions from tax on capital gains requires careful tax planning. The tax rules that must be complied with are complex. For

example, for an asset to qualify for the \$750,000 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 it is not currently being farmed by a family member, it may still be considered to be qualifying farm property and therefore any gains would be eligible for the \$750,000 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 \$750,000 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 a family farm partnership, 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 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 \$750,000 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 election. 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 would 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 on the sale of FFC shares but it's important that you consider structuring 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 \$750,000 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 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 \$750,000 lifetime capital gains exemption that can be claimed against capital gains realized on transfers of ownership of qualifying farm property (and 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 \$750,000 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 \$750,000 capital gains exemption

If you plan to realize capital gains on your farming property and claim your \$750,000 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 tax 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 \$67,668 (for 2011). Your OAS benefits will be completely eliminated when your net income exceeds approximately \$109,764. 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 \$32,000 (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, by 125% of any ineligible dividends and by 141% in 2011 (138% for years after 2011) of any eligible dividends you actually receive from the corporation in the year.

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

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 the corporate attribution rules.

Income splitting with your spouse and children

Splitting income with your spouse is also made easier if your corporation is an SBC. If you ensure that your corporation maintains its status as an SBC, the corporate attribution rules mentioned above will not apply.

As discussed, the Income Tax Act contains a special income splitting tax known as "kiddie tax" on certain types of income received by minor children — including dividends received from a private corporation. The tax is applied at

the top personal rate for individuals, without the benefit of personal tax credits (other than the dividend tax credit). This tax effectively eliminates most of the benefits provided by splitting income with your minor children. In addition to private company dividends, the tax also applies to rental income, interest income, and any other property income earned by a trust or partnership from a family business that is taxed in the hands of minor children.

It should be noted that in the 2011 federal budget, a proposal was announced to further extend the kiddie tax to apply to capital gains. Under this proposal, the kiddie tax rules will be expanded to capital gains realized by, or included in the income of, a minor from the disposition of shares of a corporation to a person who does not deal at arm's length with the minor, if taxable dividends on the shares (if paid) would have been subject to the tax on split income. Where capital gains are caught under this rule, they will be treated as dividends for tax purposes. This means that beneficial capital gains inclusion rates will not apply and the income will not be eligible to be offset by the capital gains exemption. As well, this deemed dividend cannot be designated as an eligible dividend and the corporation will not be able to treat the amount as a dividend paid. This change will deny proper tax integration and a dividend refund for the corporation if it has a refundable tax.

As noted earlier, shares of an FFC can be gifted to an adult child without a capital gain. Dividends paid on these shares would be taxable to the adult child.

For more information on income splitting, see our *Income Splitting* bulletin.

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.

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 significant balances of inventory with no tax cost and are 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. 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. (Note that under the current Ontario legislation, both of these threshold tests must be met for CMT to apply).

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 you maintain your corporation as an SBC or an FFC. However, there are many tax and non-tax issues that you need to consider before you make the decision to incorporate. Contact your BDO tax advisor for further details on how you can use these planning ideas in your situation.

| Comparison of Tax Rates | | | | | | | |
|--|--|--------------------------------|---------------------------|----------------------------|-------------------------------|---|--|
| Tax Deferral and Integration With the Use of a Corporation - 2011 | | | | | | | |
| | Corporate/Personal Tax Rates ⁽¹⁾ | | | Potential Deferral | | Integration: Effective Tax Rates on Income Taxed in a Corporation ⁽²⁾ | |
| | Small Business Tax Rate (%) | General Corporate Tax Rate (%) | Top Personal Tax Rate (%) | At Small Business Rate (%) | At General Corporate Rate (%) | Active Income Earned in a Corporation and Net Income After-tax Paid out as a Dividend | |
| | | | | | | At Small Bus. Rate: Ineligible Dividend (%) | At General Corporate Rate: Eligible Dividend (%) |
| British Columbia | 13.50 | 26.50 | 43.70 | 30.20 | 17.20 | 42.66 | 44.07 |
| Alberta | 14.00 | 26.50 | 39.00 | 25.00 | 12.50 | 37.83 | 39.52 |
| Saskatchewan | 13.00 | 28.50 | 44.00 | 31.00 | 15.50 | 40.91 | 45.20 |
| Manitoba | 11.00 | 28.50 | 46.40 | 35.40 | 17.90 | 45.84 | 47.62 |
| Ontario | 15.50 | 28.00 | 46.41 | 30.91 | 18.41 | 43.02 | 48.30 |
| Québec | 19.00 | 28.40 | 48.22 | 29.22 | 19.82 | 48.44 | 51.20 |
| New Brunswick | 16.00 | 26.50 | 43.30 | 27.30 | 16.80 | 41.90 | 41.91 |
| Nova Scotia | 15.50 | 32.50 | 50.00 | 34.50 | 17.50 | 46.10 | 56.02 |
| PEI | 12.00 | 32.50 | 47.37 | 35.37 | 14.87 | 48.23 | 50.95 |
| Newfoundland | 15.00 | 30.50 | 42.30 | 27.30 | 11.80 | 40.47 | 45.07 |
| Yukon | 15.00 | 31.50 | 42.40 | 27.40 | 10.90 | 40.84 | 43.64 |
| NWT | 15.00 | 28.00 | 43.05 | 28.05 | 15.05 | 40.20 | 43.34 |
| Nunavut | 15.00 | 28.50 | 40.50 | 25.50 | 12.00 | 39.62 | 46.90 |

(1) Rates used are nominal rates as at July 11, 2011 and are current to April 30, 2011.

(2) The tax rates for corporate income are the combined corporate and personal tax rates for tax paid by earning income through a corporation eligible for the small business rate or a corporation taxed at the top corporate rates. 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 2011. 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. Please note that due to increasing federal tax rates on eligible dividends in 2012, a greater cost will arise where corporate income is taxed in 2011 then paid out as an eligible dividend in a subsequent year when compared to income earned personally. This cost should be reduced in most jurisdictions for corporate income taxed in 2012 and then paid out as an eligible dividend, as the federal tax rate changes will be fully implemented.

The information in this publication is current as of May 15, 2011.

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