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When family farm corporations don't live happily ever after

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Previous issues of *Farm Alert* have discussed the benefits of incorporating a farming business,[1] factors to consider before and after incorporating,[2] and the importance of maintaining a pure farm corporation in order to take advantage of the lifetime capital gains exemption on a potential sale or transfer of family farm corporation shares.[3] This article discusses issues to be aware of when a family farm corporation must be discontinued or reorganized. A few practical scenarios demonstrate the downside of holding farm assets in a corporation.

Discontinuing the farming operation during lifetime

When no children are interested in continuing the farming operation, the shareholders may wish to wind up the farm corporation. Unfortunately, there is no opportunity to defer tax when a farm property is transferred from a corporation to its shareholders. The corporation will be considered to have transferred the assets to its shareholders at their fair market value. The transfer may result in recapture of capital cost allowance claimed on depreciable property (e.g. machinery, equipment, barn, vehicle and quota) and gains on capital property (e.g. farmland and quota). The assets that the shareholders do not want to keep must be sold. Income tax will likely be payable by the corporation.

The distribution of cash (after tax proceeds from sale of assets) and the transfer of remaining assets to the shareholders will be treated as a dividend for tax purposes. The drawback here is the corporation and shareholders will be required to pay taxes on assets that have not yet been sold, and the shareholders lose the opportunity to use their lifetime capital gains exemptions on those gains recognized in the corporation. If the shareholders retain the cash in the corporation and take it out over several years, they may be able to take advantage of lower personal marginal tax rates.

Splitting the operation

Often in farming operations, the children wish to split the business into separate operations – for example, milking operations to one child and cropping to another, or each child receives one of two farms. From an income tax perspective, it is much easier to divide assets held by a farm corporation on a tax-deferred basis while the parents are alive and controlling the farm corporation.

Reorganizing or splitting the operation where many individuals are involved can result in adverse tax consequences. For example, if two brothers are considering incorporating their farming business, they should understand that it will be difficult to "undo" the incorporation.

Death of a shareholder

Upon the death of a shareholder of a family farm corporation, shares held at the time of death may be transferred to the deceased's spouse and/or children on a tax-deferred basis. There may be an opportunity to make use of the lifetime capital gains exemption on some or all of the shares held by the deceased. Problems may arise subsequent to the shareholder's death when non-farming children want immediate cash for their shares and farming children want to continue the farming operation. The ideal option for farming children involves the

1 "Old MacDonald had a farm corporation," Collins Barrow *Farm Alert*, Summer 2007.
2 "Before and after incorporating your farming business," Collins Barrow *Farm Alert*, November 2012.
3 "Maintaining a pure farm corporation," Collins Barrow *Farm Alert*, July 2013.

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corporation borrowing money to buy back the non-farming children's shares. The corporation may be able to deduct interest on that loan. The proceeds received by the non-farming children will be considered dividends and taxed at a rate that is higher than the rate for capital gains.

It is more likely that the non-farming children would prefer selling their shares, triggering capital gains and the ability to use their lifetime capital gains exemption (or taxed at a rate that is lower than the dividend tax rate). In such a situation, the farming children may be forced to borrow personally to buy the shares of the non-farming children. While the buyer will likely be able to deduct the interest paid on that loan, any withdrawal by the buyer from the corporation to repay the capital and interest will be treated as a dividend.

Where the buyer and seller are dealing with each other at arm's length, it may be possible to structure the transaction so the farm corporation assumes the loan. When the share sale is between related parties (e.g. siblings), the transaction is considered to be non-arm's length under the *Income Tax Act* and thus the loan cannot be assumed by the farm corporation. Although the *Income Tax Act* does not specify certain individuals (such as cousins) as "related," it would be difficult to convince the Canada Revenue Agency that a share sale transaction between cousins consisted of arm's-length parties.

If the children of the deceased wish to split the operations into separate entities, there may be adverse tax consequences similar to transferring assets from a corporation to its shareholders, as discussed above. As well, the situation can be complex when, upon a shareholder's death, non-farming children wish to hold the shares for sentimental reasons and may not cooperate with the farming children in business decision-making and any future reorganization of the corporation.

Conclusions

The above scenarios demonstrate that transferring entire farm assets into a family farm corporation is not always the best strategy. Generally, significant value of a farming operation will be attributable to farmland and quota. Keeping farmland in the individual's hand provides flexibility for future tax-deferred rollovers of specific parcels of land to different children, and also provides for the potential use of the lifetime capital gains exemption on future increases in land value.

In certain circumstances, a partnership may provide more flexibility in transferring the assets on a tax-deferred basis to the partners when farming operations are discontinued. Where the tax cost (adjusted cost base) of the partner's interest in the Canadian partnership is equal to the aggregate cost amount of the partner's *pro rata* share in the partnership property, the *Income Tax Act* permits tax-free transfer of partnership property to the partners. In addition, the partnership provides the ability to allocate capital gains on sales of properties to the partners so they may use their lifetime capital gains exemptions.

The GST/HST issues on discontinuing farming operations were discussed in a previous edition of *Farm Alert.*[4]

Your Collins Barrow advisor can help you understand these issues and determine the most tax-effective structure for your succession planning.

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4 "Income tax and HST implications of ceasing farm operations," Collins Barrow *Farm Alert*, March 2014.