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Will you soon be paying more tax on your quota sale?

Thomas Blonde, BSc (Agr), CPA, CA, *is a partner in the Guelph Wellington Dufferin office of Collins Barrow.*

Changes to eligible capital property rules

The Canadian government is planning to change the way it calculates tax on quota sales beginning January 1, 2017. Many farmers are worried about how this will impact their operations, particularly if they are incorporated. This article seeks to clarify the coming changes and provide some suggestions to help farmers prepare.

What are the current tax rules for quota?

Quota falls into the category of intangible assets that the Canada Revenue Agency (CRA) calls eligible capital property (ECP). Under the current tax rules, the CRA allows you to write off 7% of 75% of the cost of the ECP (i.e. quota) you acquire over the years.

As an example, let's say you bought quota several years ago for $100,000. In the first year, the government will allow you to take 75% of that amount ($75,000) and write off 7% of it, or $5,250 (7% of $75,000). In the second year, the write-off would be $4,882 (7% of $69,750) and so on. After a number of years, that original $75,000 amount would eventually be written down to almost nothing.

Let's now say that the original quota you bought for $100,000 was then sold for $600,000. Let's also say you have written off all of the $75,000 permitted over the years. Under current tax rules, that $75,000 write-off will be taxed back as income on the sale. In addition, half of the $500,000 difference between the $100,000 cost and the $600,000 proceeds ($250,000) will also be taxed as a gain, so you will be taxed on a total of $325,000 ($75,000 plus $250,000). The other $250,000 half of the gain can be paid out to the shareholders tax-free through the company's Capital Dividend Account (CDA).

If this $325,000 income was then earned in a farming corporation that qualifies as a Canadian-controlled private corporation (which most do), you would initially be taxed at a low corporate rate. In Ontario, this rate is 15% for the first $500,000 of income earned. So in this example, assuming total farming income was under $500,000, the corporation would pay tax initially at just 15% on the $325,000, or $48,750 on the sale.

However, this is just the *corporate tax* payable. There will also be another layer of personal tax payable when the funds are eventually paid out of the company. This personal tax payable depends on the personal tax brackets of the shareholders.

If you do not require the money for personal purposes right away, you have the opportunity to leave the funds in the company and pay only the corporate tax immediately. This strategy is especially advantageous when corporate income is under $500,000 and you pay a rate of just 15% in Ontario or between 11% and 19% in other provinces. However, even if income is over $500,000, there is still an advantage as the high-rate corporate tax rates range between 25% and 31%. You can leave the excess funds in the company over the years to invest and defer paying the personal tax portion as long as possible.

How will the rules change in 2017?

The 2016 Federal Budget proposed changes to how ECP, including quota, will be taxed. These changes will be effective January 1, 2017. Instead of having its own tax rules, quota will now be taxed like other depreciable assets, such as buildings and equipment. Under these rules, 100% of the quota cost (rather than 75%) will be written off at 5%, rather than 7%. In addition, any gains will be taxed as regular capital gains, rather than business income.

Consider the above example again. Under the new rules, the $75,000 would still be taxed as regular business income.

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However, the $250,000 taxable portion of the capital gain would be taxed as investment income, rather than business income. The distinction is important: investment income is taxed at high rates inside companies. In Ontario, for example, investment income is taxed at 50.17%, with a portion going into a refundable account (discussed below).

Returning to the example, the corporation would pay 15% on the $75,000, or $11,250, and then 50.17% on the $250,000 gain, or $125,425, for a total tax bill of $136,675. Clearly, this is significantly more than the $48,750 in tax that you would have paid if you sold the quota in 2016. It should also be pointed out though, that under the new rules, half of the gain ($250,000 in this example) can still be paid out to the shareholders tax-free through the company's Capital Dividend Account (CDA).

But this is not the end of story. In fact, 30.67% of the 50.17% that you would pay ($76,675) is a refundable tax that will be refunded to the company when dividends are paid out to the shareholders. After the refund, the net tax the company would pay under the new rules in Ontario would be 19.5%, rather than 15% under the old rules – a 4.5% difference (assuming all of the income was taxed at 15%).

There is a catch, however. In order to get the $76,675 refunded, you must now pay out $200,039 to the shareholders as taxable dividends. ($38.33 of the tax is refunded for each $100 of dividends.) Paying out this $200,039 to shareholders will result in another layer of personal tax that could exceed the $76,675 refundable tax. Thus, in many cases you will no longer have the ability to defer a portion of the taxes payable as you did under the old rules.

How can I prepare for the changes?

First, determine whether you should even be concerned about this change. If you are not planning to sell the quota for many years, it's likely that you should do nothing unless you plan to draw significant dividends from the company in the future. This would include scenarios in which your children are planning to take over and carry on the farm for many years.

If you are planning to sell the quota soon, the simplest strategy is to accelerate the quota sale to 2016. If you were planning to wind down your company immediately after the sale, the difference in taxes payable under the old rules compared to the new ones might result in a slight tax savings if the sale occurs in 2016, rather than 2017.

If it is not possible to accelerate the sale, you might consider some re-organization solutions. For example, depending on the rules and regulations of your marketing board it may be possible to sell the quota to yourself or a related company or individual at fair market value to pre-pay the tax using 2016 rules and lease the quota back to the company. This strategy might require a loan to finance the tax payment until the quota is sold to a third party in the future. In addition to the tax pre-payment, this strategy could add a significant amount of administrative cost and complexity. However, the costs may be worthwhile if you expect a large gain on your quota *and* you also want to keep your company around to defer paying the personal tax portion as long as possible – particularly since you could "bump up" the value of quota to fair market value and thus receive a larger deduction for quota depreciation (CCA) in future years.

The above scenario is more attractive where all or a portion of the taxable gain on the quota sale may be taxed below the $500,000 threshold and therefore subject to the lower tax rate (i.e. 15% in Ontario), rather than the higher rate payable if the income is above $500,000. Your advisor can help you determine whether this strategy would ultimately be worthwhile in your case.

What if I am not incorporated – does this affect me at all?

The most significant impacts of the new taxation rules for quota apply to incorporated farms. However, unincorporated farms may

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still face consequences. Under the old taxation rules, gains on quota sales were not subject to the alternative minimum tax (AMT) calculation when the capital gains exemption was used on a quota sale. Under the new rules, the gain on the quota sales will be part of the AMT calculation. Consequently, you could be subject to a significant amount of this AMT under the new rules if you use your capital gains exemption on the quota sale, even though there may not be any regular tax to pay. Note, however, that AMT is refundable against taxes otherwise payable over the next seven years. It may also be possible to eliminate or minimize AMT by taking back a loan on the sale.

Can I benefit from this change?

There is a way to benefit from the new rules if you are in the process of purchasing quota. If you purchase the quota before the end of 2016, you may take advantage of some transitional rules permitting you to write off the quota slightly faster than you otherwise could. Thus, anything you can do to accelerate a quota purchase to before December 31, 2016, would be to your benefit. This opportunity is available to incorporated and non-incorporated entities.

In addition, with both corporate and non-corporate owned quota, the taxpayer may apply any capital losses they have available to offset the gain on the quota sale. This option was not available under the old rules except where a special election applied.

The consequences of the changes to the tax rules for quota can be complex. This article highlights some of the key issues, but it is important to contact your Collins Barrow advisor for help and more information.

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