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Proposed tax changes for family farm corporations

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On July 18, 2017, Minister of Finance Bill Morneau proposed comprehensive changes to the taxation of private corporations, based on concerns that private corporations "give unfair tax advantages to certain – often high-income – individuals." While these proposed amendments will affect all private corporations, several of the proposals will have a significant impact on tax planning for family farm corporations (FFCs) and on inter-generational transfers of farm property (e.g. land, shares of FFCs or an interest in a family farm partnership).

The changes target three key tax planning strategies currently used by many FFCs:

1. income sprinkling;
2. multiplying the capital gains deduction; and
3. passive investments.

The consultation period, with respect to this proposed legislation, ends on October 2, 2017, after which the final legislation will be tabled.

Income sprinkling

Currently, FFCs can transfer income from an individual farmer who may be in a higher tax bracket to those family members who are in lower tax brackets or who may not be taxable at all. For example, compare the taxation of a farmer who is not incorporated with the taxation of an FFC where the spouses are shareholders. Assume that only the farmer is active in the daily operations of the farm and that the farmer and the farmer's spouse have no other sources of income.

	Unincorporated farmer	FFC
Gross income	$250,000	$250,000
Corporate tax (combined rate of 15 per cent)	N/A	($37,500)
Funds taxable to individual(s)	$250,000	$212,500
Individual(s) tax *	($94,000)	($35,500)
Net after-tax earnings	$156,000	$177,000

* Based on Ontario personal tax rates in effect for 2017 and assuming that the distributions made by the FFC are 50/50 to the farmer and the farmer's spouse by way of dividend.

The farmer in the FFC situation pays $21,000 less tax. The Department of Finance has determined this savings to be an "unfair tax advantage." Consequently, commencing January 1, 2018, a proposed "reasonableness test" will apply for common sources of farm income distributions (e.g. wages, partnership income and dividend income). This test will be based largely on contributions the income recipient has made to the business in the form of labour or capital and whether any risk was assumed by

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the recipient. If the income received is not commensurate with the contributions made or the risk assumed by the recipient (in addition to other criteria), the income may be deemed “unreasonable” and subject to tax at the top marginal rate of approximately 50 per cent.

Multiplying the capital gains deduction

Presently, up to $1 million of capital gains realized on eligible farm property (which includes qualified farmland, qualified shares of an FFC, qualified interests in farming partnerships and quota) can be realized tax-free with the use of an individual’s capital gains exemption. To minimize tax on the dispositions of eligible farm property, tax planning for farms has often involved using the capital gains exemption of various family members, thereby multiplying the available $1 million by the number of family members owning the eligible farm property.

To counteract this type of planning, the Department of Finance has proposed that children under the age of 18 may not claim a capital gains deduction on a disposition of any property, including eligible farm property. In addition, the proposals include a provision that children aged 18 or older also may not claim a capital gains deduction for any increase in value of the eligible farm property that was realized before their 18th birthday. To comply with this requirement, farmers will have to obtain and retain information to support the value of the property at the time each child turns 18.

Current farm tax planning should consider the use of the farmer’s capital gains deduction on the increase in the value of the property up to the date the child turns 18, as the child will be unable to use their capital gains deduction on this portion of the capital gain no matter how old they are. Previous tax planning using family trusts should also be revisited, as all capital gains allocated from a family trust will no longer be eligible for the capital gains deduction under the new proposals.

To complicate matters further, the Department of Finance has also proposed a reasonableness test for capital gains realized on farm partnership interests and FFC shares. (The test will have similar critera to that of the reasonableness test outlined under “income sprinkling” above.) The reasonableness test will be far more stringent for individuals aged 18-24. The portions of any gains deemed to be unreasonable will be taxed at the highest marginal tax rate of approximately 50 per cent.

Proposed 2018 election

Farmers who filed a 1994 personal tax return might remember the 1994 capital gains election that was instituted when the general $100,000 capital gains exemption on most types of assets was repealed. This one-time election allowed taxpayers to “bump up” the tax cost of a property by $100,000, reducing the future capital gain to be realized on that property by $100,000.

A similar measure has been proposed for 2018 due to the planned changes in eligibility of qualified farm property for the capital gains exemption. An individual, including a child, may elect to use their capital gains deduction on certain farm property, using the current tax rules, thereby guaranteeing that a future disposition of the property will result in a reduced future tax liability. Adults may elect to use the capital gains deduction on all three types of qualified farm property, but children under 18 may only elect to use their capital gains deduction on farmland and partnership interests, not FFC shares.

Some significant tax planning must be done prior to making this election, as the capital gain may result in alternative minimum tax (AMT), which could be as high as $56,600 for an Ontario resident with no other income. The AMT is refundable against future personal taxes owing over the following seven years, but some individuals, particularly children, may not generate enough personal income and related taxes during this time to recover the entire AMT amount paid.

An additional “tax trap” arises if any of the farm property used for an election was transferred to the individual after December 31,

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2015, under the existing farm rollover rules. Under the current legislation, the election gain will revert back to the original transferor of the farm property. If the transferor does not have sufficient capital gains deduction remaining, the elected 2018 gain by the transferee will result in a significant tax liability to the transferor.

Passive investments

Many FFCs retain excess earnings, rather than pay the accumulated funds out to shareholders, thereby deferring the application of higher personal tax rates. Instead, the retained funds are invested in passive investments within the FFCs, such as stocks or GICs. The Department of Finance is proposing to tax investment income earned on these passive investments at significantly higher corporate tax rates to encourage shareholders to withdraw the funds from FFCs and pay tax on the investments personally.

The proposed legislation to eliminate the Department of Finance's perceived unfair tax advantages will have a substantial impact on future tax planning for all family farms. To avoid any associated negative tax consequences, it is important to discuss the effects of the proposed changes with your accounting advisor.

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