FARM ALERT



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# Farm corporations and claiming the small business deduction

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Historically, the Government of Canada has supported the agricultural sector with favourable rules in the *Income Tax Act (the Act)*, among other strategies. Recently, the government announced its intention to lower the small business tax rate from 10.5 per cent to 10 per cent, effective January 1, 2018, and to 9 per cent on January 1, 2019. Reduction of the small business rate makes it more attractive for farmers to incorporate their farming operations. Although the lower corporate tax rate is only a tax deferral, it will help many farmers – especially those financed with debt – by providing more after-tax cash to repay their debts faster.

Unfortunately, changes introduced in the 2016 Federal Budget to the small business deduction rules (which were intended to catch structures that multiplied the small business deduction), are creating complexity and concern for farmers who have incorporated. The changes have limited the ability of corporations in the agricultural sector (farm corporations) to claim small business deductions in many common business transactions. The changes to the small business deduction are discussed in the November 2016 Tax Alert. This article focuses on the implications of the changes to farm corporations.

**What has changed?**

The changes apply to taxation years beginning on or after March 22, 2016. The term, "specified corporate income" introduced in the Act, will include any income from an active business received by a farm corporation and earned by providing property or services to a private corporation in which the farm corporation, a shareholder of the farm corporation, or a person who does not deal at arm's length with such shareholder has a direct or indirect interest in the private corporation. The term "direct and indirect interest" includes a small percentage of shareholding. In addition, the term "indirect interest" is broad and can include shareholding through a holding corporation, holding of options or rights to acquire shares, a beneficiary of a trust and more. Indirect interest also includes the amounts loaned to the corporation.

**Consequences for farm corporations**

Income that is treated as specified corporate income will not be eligible for the small business deduction. A private corporation that receives the property or services may assign (i.e. share) a portion of its small business deduction limit to a farm corporation. If a private corporation does so, the Act grants the CRA the power to determine whether the limit assigned by the private corporation is reasonable. Farmers are aware that the existing associated corporation rules require farm corporations to share the small business deduction limit with the associated corporations. In addition to the complex associated corporation rules, the specified corporate income rules make it more difficult for farm corporations to comply with the Act, particularly given that the CRA seems to have discretion in determining the specified corporate income amount.

Where all or substantially all of a farm corporation's income for the year from an active business is from transactions with arm's length parties, the Act exempts the entire income from the specified corporate income rules. The term "all or substantially all" is not defined in the Act, but the CRA has interpreted it to mean 90 per cent or greater.

**An example of how the changes will affect farm corporations**

Generally, farmers in rural areas transact with businesses within their communities because they have a strong business and personal relationship with their customers and suppliers

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established over generations. For example, it would make more sense for a farm corporation in a rural area to sell seeds to a private corporation in the same community, or to use the trucking services or custom work of that private corporation. If the private corporation is owned by a relative, or if the farm corporation does not deal at arm's length with the private corporation, and if the income from selling seeds to that private corporation is more than 10 per cent of the farm corporation's income, the income from seeds will be specified corporate income and will not be eligible for the small business deduction. In other words, the farm corporation will not benefit from the government reducing the federal tax rate to 10 per cent in 2018 unless the private corporation decides to share some of its small business limit.

If the private corporation's own taxable income is equal to or greater than the current small business limit of $500,000, the private corporation will not want to share the small business limit with the farm corporation. In addition, if the private corporation's taxable capital is more than the current threshold of $15 million, the private corporation will not have a small business deduction limit to share with the farm corporation.

"Income" in the specified corporate income rules is understood to mean revenue net of expenses. In the above example, the farm corporation must track the expenses related to the seed sales to the private corporation to determine the net income that will be characterized as specified corporate income.

**Implications for farm corporations dealing with co-operative corporations**

Farm corporations that sell products to co-operative corporations will see a limitation on their ability to claim the small business deduction. In response to concerns raised by the public, the government introduced amendments to the Act for farm corporations that deal with eligible farming co-operatives, to exclude them from the changes. However, farm corporations that deal with non-qualifying co-operatives and co-operative-like structures will still be caught by the new changes.

**Compliance will be challenging**

The changes to the small business deduction rules are broad. It will be difficult for many farm corporations to recognize that their transactions may be caught under the new rules. In addition, the onus will be on farm corporations to prove that the new rules do not apply to them, or they risk additional taxes and perhaps interest and penalties. Until the government introduces changes to the Act to correct the unintended consequences, farm corporations should analyze their revenue sources to determine whether the income will be caught under the specified corporate income rules.

Your Collins Barrow farm tax advisor can help you understand these rules and determine the impact the changes will have on your farm corporation.

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