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Class 14.1 tax changes for quota in 2017

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Farmers and farm corporations in supply management sectors buy and sell quota regularly. While operational and financial considerations rightly drive these transactions, they are sometimes completed without considering the tax implications. Consequently, these transactions can lead to unexpected income tax results.

Effective January 1, 2017, the income tax treatment of farm quota and other eligible capital property (ECP) underwent a complete overhaul. First announced in the 2016 Federal Budget, the ECP regime was formally replaced by capital cost allowance (CCA) class 14.1 on January 1, 2017.[1] With many farmers and farm corporations' 2017 fiscal year-ends now approaching, farmers should be aware of the implications of these changes to their businesses.

In an earlier Farm Alert, Thomas Blonde provided a more comprehensive overview of these changes. This article highlights a few practical tax issues with the new regime that farm businesses may encounter.

What changed?

On the surface, the changes appear cosmetic. Instead of providing for a 7 per cent annual deduction on 75 per cent of the cost of quota (effectively 5.25 per cent), CCA class 14.1 provides a 5 per cent annual deduction on 100 per cent of the cost of quota acquired after December 31, 2016. Existing balances in the cumulative eligible capital (CEC) pool of ECP are converted to undepreciated capital cost (UCC) balances in class 14.1 on January 1, 2017. Sales of quota in and after 2017 will be treated as other dispositions of depreciable property. Transitional rules[2] provide relief for existing CEC balances originally capitalized at only 75 per cent, fiscal years that straddle January 1, 2017 and small class 14.1 UCC balances.

What if the farm holds multiple quotas?

Under the pre-2017 rules, all quotas and other CEC were treated as a single tax pool. Consider a farm that carries on both a dairy and broiler operation. Let's say the farm acquired dairy quota at a total cost of $2,000,000 and broiler quota at a total cost of $1,000,000, leaving it with a CEC balance in 2016 of $1,800,000. If this farm sold all its broiler quota to an arm's-length party in 2016 for $1,600,000, the sale would trigger no income for tax purposes. The CEC would decrease by 75 per cent of the proceeds ($1,200,000), leaving a CEC balance of $600,000 to deduct over time.

This same set of facts with the sale of broiler quota in 2017 (instead of 2016) leads to a much different result. The $1,800,000 of CEC would convert into a class 14.1 UCC balance on January 1, 2017. However, the sale of quota as a depreciable property requires the farm to deduct the lesser of cost ($1,000,000) and proceeds ($1,600,000) from the class 14.1 UCC in 2017. The farm can only consider the original cost of the broiler quota in this example because the broiler and dairy quotas are distinguishable properties within class 14.1. Transitional rules[3] provide for a notional bump in the UCC of $250,000 (25 per cent of the lesser of original cost and proceeds) to recognize that only 75 per cent of the original cost was added to CEC. Thus, the farm would be left with a class 14.1 UCC balance of $1,050,000 ($1,800,000 - $1,000,000 + $250,000) to depreciate in future years.

But that's not the end of the story. The farm would also realize a capital gain of $600,000 ($1,600,000 proceeds - $1,000,000 original cost), half of which is taxable at the farm's income tax rate. For either an individual or a corporation, this rate could be over 50 per cent, leading to additional tax after 2016 of up to approximately $150,000 in this example.

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What if the farm sells only a little quota?

Some supply management boards, such as Dairy Farmers of Ontario, provide farms meeting certain criteria with additional quota allocations periodically. Some of these farms regularly sell these quota allocations to generate cash for other farm business needs. Before 2017, these sales would typically create no tax consequences.

After 2016, the rules described above will create taxable income on almost all these small quota sales. The CRA views units of a particular farm quota, such as dairy quota, to be indistinguishable "identical properties."[4] The cost of each unit of a particular farm quota is calculated by averaging the cost of all units of that quota. For example, a sale of a unit of dairy quota for $24,000 with average cost of $10,000 would lead to a capital gain of $14,000. This formerly tax-deferred transaction is now subject to immediate tax at capital gain rates.

What if the farm buys a replacement quota?

Before 2017, a farm could transition between supply-managed sectors tax free in certain circumstances. For example, a farm transitioning from a dairy to a broiler operation could sell its dairy quota for $2,000,000 and buy broiler quota for $2,000,000 without immediate tax consequences. CEC would increase by $1,500,000 (75 per cent of the cost of the broiler quota) and decrease by $1,500,000 (75 per cent of the proceeds for the dairy quota). If these transactions both occurred in 2016, there would be no net change in CEC and no taxable income inclusions for this transition. After 2016, the disposition would be subject to tax under the capital gains treatment discussed above.

Furthermore, if the acquisition of broiler quota took place in the tax year following the disposition of dairy quota, former subsection 14(6) of the *Income Tax Act* (ITA) provided a tax deferral on acquisition of replacement ECP. After 2016, the only replacement property provisions available for quota transactions would be on involuntary disposition (i.e. by theft, destruction, or expropriation) of the former quota under subsection 13(4) of the ITA. The CRA has confirmed that farm quota would not qualify for replacement property treatment for ordinary dispositions under these new rules effective in 2017.[5] Therefore, farmers can no longer rely on replacement property tax deferrals for their quota.

What if the farm transfers the quota to a corporation?

Before 2017, farmers and farm corporations could transfer quota to a corporation under certain rollover provisions in section 85 of the ITA. Assuming the other conditions were met, the transferor could receive cash or debt from the corporation tax free as consideration, up to 4/3 of the balance of CEC transferred. This bump in permitted tax-free consideration accounts for the fact that only 75 per cent of the cost of the quota was originally added to CEC on acquisition.

After 2016, however, this cost bump no longer applies on these rollover transactions. Transferors now receive only the balance of class 14.1 UCC, which equals the former CEC, as tax-free cash or debt from the corporation. Effectively, the new regime reduces by 25 per cent the debt that a farmer can transfer tax free to a corporation as consideration for quota acquired prior to 2017. The rulings division of the CRA has confirmed our interpretation of these rules and referred our comments to the Department of Finance. Legislative amendments to improve the neutrality of the transitional rules – based on the dates quota is acquired and transferred – appear to be necessary, but none have been announced at the time of this writing.

What impact do the July 18 tax proposals have on the sale of farm quota by corporations?

The government released a consultation paper on July 18, 2017,

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proposing sweeping changes to the taxation of private corporations. In an earlier Tax Flash, Rainer Vietze summarized the lengthy proposals, which would undoubtedly impact most family farm corporations.

Two items in particular from the consultation paper could bear a significant impact on dispositions of farm quota by corporations. First, half of the gain on disposition of farm quota adds to the corporation's capital dividend account, whether as calculated under the old rules and available at the start of the next fiscal year or under the new rules and available immediately. Proposed new legislation[6] could deem any capital dividends paid after July 18, 2017, as a result of any sale of quota to be taxable dividends. Second, the government requested input on how to overhaul the investment tax system for private corporations, which could include increasing corporate taxes on taxable capital gains.

Stay tuned for further comments on the proposed tax changes as the fall economic update approaches.

What should supply-managed farmers do?

The new rules for farm quota are complex. The transitional rules are more complicated and the private corporation tax proposals even more so. This article highlights broadly the changes and issues they present. Contact your Collins Barrow advisor for more assistance with your particular goals and circumstances.

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[1] Introduced when the bill to repeal section 14 of the Income Tax Act (ITA) received royal assent on December 15, 2016.
[2] Found in new subsections 13(38) to 13(42) of the ITA.
[3] Found in paragraph 13(39)(a) of the ITA.
[4] See CRA technical interpretation 2016-0660861E5 (September 27, 2016).
[5] See CRA technical interpretation 2016-0666901E5 (November 4, 2016).
[6] Proposed new section 246.1 of the ITA, as currently drafted.