

Incorporating your farm

Is it right for you?



RBC Royal Bank



The following article was written by RBC Wealth Management Services

If you have considered incorporating your farm, investigate the advantages and the costs of incorporating. This article highlights some financial planning pros and cons that may help you determine whether incorporating your farm is right for you.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from qualified tax and legal advisors before acting on any of the information in this article. (Note: The term “spouse” used in this article also refers to common-law partner or same-sex partner.)



By incorporating your farm, you gain access to a number of different forms of remuneration, for example, salary, dividends, and bonuses.

Farm ownership structures

The 2011 Census of Agriculture indicated that there are over 200,000 Canadian farms, comprising over 160 million acres of land. While there are several ways to structure the ownership of these farms, the most common are a sole proprietorship, a corporation or a partnership. Running a farm as a sole proprietorship is the easiest solution from an administrative and cost point of view. In fact, according to the Census of Agriculture, over 55% of farms operate as sole proprietorships. However, incorporation may provide certain benefits.

Advantages of incorporation

There are several advantages to incorporating your farm. The following is a non-exhaustive list of these advantages:

Income splitting opportunities

Incorporating a farm may allow a farmer to take advantage of income splitting opportunities. By adding lower income-earning adult family members as shareholders, the incorporated farm can pay them dividends to take advantage of their lower marginal tax rates. However, note that dividends from private corporations paid to minor children will be taxed at the top marginal tax rates (commonly referred to as the “kiddie tax”).

Additionally, the incorporated farm can pay reasonable salaries to lower income family members for the services they provide, allowing family members to take advantage of their lower marginal tax rates.

Capital gain exemption

The capital gain exemption allows you to shelter up to \$813,600 (for 2015, indexed thereafter) of capital gain when you sell your farm property, provided certain criteria is met. This exemption is available on qualified farm property whether incorporated or not. However, certain farm assets do not meet the criteria of qualified farm property. For example, inventory is not qualified farm property and you will not be able to use the capital gain exemption when you sell your farm inventory. However, if you incorporated your farm, the sale of the shares of a family farm corporation does qualify for the capital gain exemption, even if that corporation owns inventory and other assets that do not meet the criteria of qualified farm property. The criteria to qualify as a family farm corporation and the associated advantages are discussed in the article titled “Selling the Farm and the Capital Gain Exemption”.

By incorporating, you may also be able to add family members as shareholders to allow your family to multiply the capital gain exemption on the future growth of the corporation.

Potential for tax deferral

If you earn income as an unincorporated farmer, taxable income is taxed at your individual marginal tax rate. If the farming income is earned by your farm corporation, the taxable income is considered active business income for tax purposes and is subject to the general corporate tax rate, at both federal and provincial levels. If your taxable income is below the 'small business limit', \$500,000 at the federal level and for most provinces, the small business deduction can significantly reduce your corporate tax rate. This lower tax rate creates a tax deferral opportunity and can allow the corporation to retain more of its earnings for reinvestment.

Flexibility in remuneration

By incorporating your farm, you gain access to a number of different forms of remuneration, for example, salary, dividends, and bonuses. The ability to select the type and amount of remuneration allows you to maximize tax deferral while still taking advantage of non-tax related benefits such as creating Registered Retirement Savings Plan (RRSP) contribution room and participating in the Canada Pension Plan or the Quebec Pension Plan. For more information about taking salary or dividend from your corporation, please ask your RBC advisor for a copy of the article titled "Salary vs. Dividend Income".

Implementing an Individual Pension Plan (IPP)

An IPP is a defined benefit pension plan that a corporation, including an incorporated farm, can set up for its owner or key employees. The IPP is not available to unincorporated individuals (including unincorporated farmers). It is usually set up for one individual member but the benefits can be extended to your spouse, if he or she is employed by the farm corporation. In certain situations, an IPP can provide greater annual contribution room than an RRSP. Contributions made to an IPP are deductible from the incorporated farm's income. An IPP is ideally suited for individuals over the age of 40 whose typical earnings are at least \$125,000 per year.

In addition to annual contributions, additional tax deductible contributions may also be made to the IPP if investment returns in the plan are less than the 7.5% expected actuarial interest rate (in some provinces, this additional contribution is a requirement).

Income earned inside a farm corporation is eligible for the small business deduction, which allows a corporation to have its income taxed at a lower rate.

Assets in an IPP may benefit from creditor protection, but may also be subject to locking-in provisions during retirement. For more information on IPPs, please consult your RBC advisor.

Corporate owned life insurance

If you need life insurance, for example to provide income protection for survivors, or to pay taxes incurred on death, a corporate-owned, tax-exempt insurance policy may be a solution. Life insurance premiums are generally not tax-deductible. However, it is usually less expensive to fund the policy using after-tax corporate dollars as opposed to after-tax personal dollars, since income earned in a corporation may benefit from the small business deduction (as mentioned above). For example, if the incorporated farm's tax rate is 15% and the farmer's effective tax rate is 40%, corporate-owned insurance allows you to fund the policy using \$0.85 after tax rather than \$0.60 after tax where the policy is personally owned and the policyholder is in a high tax bracket. Provided the corporation is both the policyholder and beneficiary of the insurance policy, the farmer will generally not be assessed as having received a shareholder benefit.

In the event of the death of the life insured under the corporate life insurance policy, the non-taxable death benefit is paid to the incorporated farm. This increases the corporation's capital dividend account by the amount of the insurance proceeds received in excess of the policy's adjusted cost basis. The balance in the capital dividend account may be paid tax-free to the surviving shareholders or ultimate beneficiaries, or used to redeem the shares of the deceased farmer.

Incorporated farmers need to be aware of the cash surrender value of the life insurance policy. To qualify for the capital gain exemption, a minimum amount of farm corporation assets must be used in the active farming. If the total non-active farming assets, such as the cash surrender value of the life insurance policy, is large enough, it may disqualify the farm corporation and the capital gain exemption may not be available.

Retirement of debt

As explained above, income earned inside a farm corporation is eligible for the small business deduction, which allows a corporation to have its income taxed at a lower rate. By reducing the taxes paid, the farm corporation will have more funds to repay its outstanding debt than it would if the farm was structured as a sole proprietorship. This can allow the debt to be paid off faster and reduce the amount of interest paid.

Liability issues

The creditors of an unincorporated farmer could seize the personal assets of the farmer for any outstanding business debts. However, as a corporation is a separate legal entity, the creditors of a farming corporation cannot generally seize the personal assets of an incorporated farmer unless he/she gives personal guarantees for the loans of the corporation. Note that any asset protection strategy should be undertaken when there are no existing creditor claims or potential creditor claims. Always consult a qualified legal advisor before exploring the asset protection options available to you.

Ability to implement estate freeze

Incorporating your farm can allow you to freeze the value of your farm at a certain point in time and allow future growth to occur in the hands of future generations. You may also be able to take advantage of the capital gain exemption when you implement the freeze. This strategy is discussed further in the article titled “Transferring Your Farm to the Family”.

Ability to transfer inventory to children on tax-deferred basis

You can transfer farm assets to your children on a tax-deferred basis if certain conditions are met. However, this tax-deferred rollover is not available on the transfer of certain farm assets, such as inventory. If you are planning to transfer your farm to your children and the assets you are transferring include inventory which has appreciated in value, it may make sense to transfer the farm assets into a corporation and then transfer the shares of the corporation to your children instead.

Non-tax related benefits

A corporation can offer benefits that are not available to sole proprietors. These include: group disability and health insurance and benefits under a Registered Pension Plan.



Incorporating your farm can allow you to freeze the value of your farm at a certain point in time and allow future growth to occur in the hands of future generations.

Disadvantages of incorporation

While incorporating your farm may provide certain benefits, weigh these benefits against the potential disadvantages of incorporating, which can include:

Costs

The initial and on-going costs of incorporating your farm can be significant. Professional legal and financial advice will be required to set-up a corporation and ensure that the proper records and legal documents are completed. Ongoing tax returns and other filings may also be required.

Use of losses

In the first few years of operation, a farm may generate losses due to high start-up costs and/or the cost of building a sales base. Farm losses can be carried back three years or forward for 20 years before they expire and become worthless. If you are not incorporated you may be able to use your farm losses to offset other sources of personal income. If your farm is incorporated, any farming losses must be applied to the corporation's income and cannot be used to offset personal income.

Complexity

Running an incorporated business is more complex than a sole proprietorship, as more legal documents, government filings and other record keeping items are required. Also worth considering are the demands that operating this kind of business structure can make on the business owner's time.

Principal residence exemption

If your farming property includes your principal residence and you are planning to transfer all the property, including the residence into a corporation, keep in mind that the corporation will not be eligible for the principal residence exemption. The principal residence exemption is available to an individual, not a corporation. Consequently, if your corporation sells the farming property (including your principal residence), it will not have access to this exemption and may incur a capital gain for the entire property (including any gain realized on the principal residence). Further, if the corporation holds an asset that you, or related parties, use for personal purposes, you may be deemed to have received a shareholder benefit and this can result in negative tax consequences. To avoid this, consider keeping your principal residence (and up to half a hectare of surrounding land) in your personal name, when transferring farming assets to the corporation.

Less flexibility with succession planning

Certain tax strategies allow you to gift qualified farm property to your children without incurring tax. If you hold farming assets personally, and they meet the criteria for qualified farm property, you can gift them to your children in a

tax-efficient manner such that they may be able to carry on a farming business, separate from one another, thereby reducing or eliminating the possibility of conflict. For example, if you own 1,000 acres of farming land personally, you could gift 500 acres to each of your two children for them to carry on their own, separate farming businesses. However, if this land was held in a corporation, your gift to each child would be shares of the corporation, requiring them to work together on the farming operations.

When deciding to set up a corporation for your farming assets, keep in mind, not all farming assets have to be transferred to the corporation. It may make sense to hold some of these assets personally to provide more flexibility in your succession plan.

Should you incorporate?

When deciding whether to incorporate your farm, you may wish to consider the following:

- Is your farm producing more income than you need for personal expenses? If so, incorporating may allow you to benefit from the income splitting strategies discussed above.
- Do you have significant sources of non-farm income which can provide you

with sufficient cash flow? If so, it may make sense to incorporate your farm. If incorporated, the farm income will be subject to the lower corporate tax rates, as opposed to your high personal marginal tax rate. You can achieve tax deferral by keeping the profits inside the corporation and pay yourself a salary or dividends in a later year when your marginal tax rate is lower.

- Do you need all or a substantial portion of your total farm and non-farm income for your annual living expenses and financial goals? If so, incorporating your farm is likely not a solution. You may not be able to benefit from the tax-deferral a corporation can offer if you need to receive a significant amount of the corporation's income as salary or dividends to cover your living expenses.
- If your farm does not have a history of profits, it may not make sense to incorporate. As mentioned above, if your farming business is your chief source of income, farm losses incurred personally can be used to offset other sources of income, which will reduce your overall tax burden. However, as losses incurred in a corporation cannot be used to offset personal income, it may not make sense to incorporate your farm if you are generating farm losses.

If you hold farming assets personally, and they meet the criteria for qualified farm property, you can gift them to your children in a tax-efficient manner such that they may be able to carry on a farming business, separate from one another, thereby reducing or eliminating the possibility of conflict.



- If you are just starting your farm business, this may not be the right time to incorporate. Farm businesses may generate losses in the first few years of operation. As mentioned above, these losses can be used to offset other sources of personal income if they are generated personally. If incorporated, the farming losses can only be used to offset income from the farming corporation in a future period.
- Are the potential tax savings from incorporating greater than the fees associated with establishing a corporation and the on-going costs of maintaining the corporation? As mentioned above, establishing a corporation can be expensive and complex and these costs should be considered in the context of the tax savings that can be achieved by incorporating.

As you can see, there are multiple factors to consider when determining whether incorporating your farm is the right decision for you. Incorporating your farm is a big decision that can have long-term ramifications. Consult with your professional financial, tax and legal advisors prior to making this decision.

Farm partnerships

An alternative farm ownership structure is farm partnership. This can be created between family members (i.e. individual, his/her spouse, and their children) or between unrelated parties. Advantages of this structure include:

- Similar to a farm corporation, it provides an opportunity to split income and therefore reduce overall total taxes paid;
- It allows an individual to add their children as partners. This gives the children the opportunity to gain experience with the farm and for the parents to ease into retirement if that is their goal;
- Partnerships typically involve less initial and on-going costs than corporations; and
- Losses distributed by the partnership can be utilized on the partners' personal tax returns subject to certain limitations.



If your farm does not have a history of profits, it may not make sense to incorporate.

In addition to these advantages, the lifetime capital gain exemption is also available for farm partnerships.

Disadvantages to this structure include:

- A partner is potentially liable for the actions of other partners. Unlike a corporation, an individual's assets outside of the partnership are potentially exposed to the claims of creditors;
- Partnership income must be distributed to the partners and is taxed at their individual tax rates. Thus a partnership is not eligible for the lower small business tax rate available to small business corporations; and
- While partnerships are typically less expensive to administer than corporations, they do require detailed record keeping and therefore, it is more expensive to maintain a partnership than a sole proprietorship.

If you decide that a farm partnership makes sense for you, it is highly recommended that you and your partners develop a partnership agreement. A strong partnership agreement details the rights and obligations of the partners relating to the partnership and typically includes the ownership of the assets, the division of profits, the methodology by which disagreements are resolved and the ability to buy the interest of other partners.

If you decide that a farm partnership makes sense for you, it is highly recommended that you and your partners develop a partnership agreement.

Summary

Farm professionals must choose how to structure their farming business. Incorporating a farm certainly has benefits, but may not make sense for all. It is important to consult your legal and tax advisors to determine which structure is best for your personal situation.



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