CCSB
CUMMINGS
COOPER
SCHUSHEIM
BERLINER LLP

Barristers and Solicitors
4100 Yonge Street, Suite 408
Toronto, Ontario, M2P 2B5
Tel: 416.512.9500 Fax: 416.512.9501
www.ccsb-law.com

PROPOSED TAX AMENDMENTS—EFFECT ON THE LIFE CYCLE OF THE FAMILY FARM

Much has been written about the Liberal Government's proposed amendments to the *Income Tax Act* (Canada) regarding tax planning using private corporations. These proposed amendments amount to sweeping changes to the income tax system. To be clear, the amendments, if enacted in their current form, will impact businesses both large and small (it is not just the "rich" who are impacted) and in virtually all industries, including farming, which is the focus of this article.

The best way to illustrate the potential impact of these proposed amendments on farmers is by way of example.

Year 1

Let's assume that Ben is a farmer. Ben is married to Sally, who is a nurse. Ben and Sally have two children: Max (10 years old) and Katie (14 years old). Ben has worked, since childhood, on the same farm as his father and grandfather. Even though they are young, Max and Katie also do some work on the farm. Sally's income from her employment has provided the family with a stable income in years of bad weather, or poor growing conditions. Ben and Sally hold the farm through a company, each of them owning shares of the family farm company.

Implications of Proposed Amendments:

Dividends paid to Ben on his shares of the family farm company will be taxed at his normal graduated income tax rate and entitled to the dividend tax credit. Since Sally is employed full time as a nurse, dividends paid to Sally will be taxed at the top marginal rate (approximately 45%), regardless of the amount of her other income. Why? The Government may determine that the amount of the dividend paid to Sally exceeds the dividend that would have been paid to someone who is not related to Ben. Under the proposed amendments, the Government gets to determine if the dividend paid to Sally is "reasonable" based on the functions she performs in the farming business, the assets which she contributed to the farming business and the risks assumed by Sally in respect of the farming business. If the Government determines that the dividend paid to Sally is "unreasonable" based on its assessment of her "contribution" to the farming business, the Government will tax the "unreasonable" portion of the dividend at the flat rate of 45%..

Middle-Aged

As time passes, and Ben gets older, he decides to undertake some estate planning. Max, now 24 years old, has taken more responsibility in operating the farm, but Ben does not believe that Max has the necessary experience yet to operate the farm on his own. Daughter Katie is 28 years old and is a speech therapist living in the city. Ben wants Max to continue to work on the farm with a view to taking it over, but also wants both of his children to participate in future growth in value of the family farming business.

In these circumstances, Ben is advised to implement an "estate freeze" of the family farm company, which typically means that Ben and Sally will exchange their common shares of the company for fixed value preferred shares with a value equal to the fair market value of the farming business at that time—say $1,000,000. These shares can be redeemed (purchased) by the company over time, with the result that Ben and his wife can extract up to $1,000,000 from the company, which normally would be taxed as dividends. As part of the estate freeze, Ben settles a family trust and gifts new common shares in the family farm company to the family trust. Future growth in the value of the family farm will go to the common shares held by the family trust, the beneficiaries of which are Max, Katie and their future children. Dividends can also be paid on the common shares held by the trust.

Retirement

When Ben is sixty years old, he has to slow down due to health problems. With another 10 years of farming under his belt, Ben now believes that Max can, with some guidance here and there, manage the day-to-day operations of the farm.

By the time he is sixty five, Ben has not been active in the farming business for five years and he and Sally want to travel. The $1,000,000 of frozen shares in the family farm company are to be redeemed to provide them with an income. This is important to Ben since he does not have a pension, or other retirement benefits like most employees.

Implications of Proposed Amendments:

Because Ben has not been active in the family farm business for five years, any dividends which Ben receives from the family farm company on the redemption of his shares, will likely be taxed at a flat rate of approximately 45%. Any dividends which Sally receives on the redemption of her shares in the family farm company will also be taxed at the flat rate of approximately 45% since she has never been involved in the business.

Dividends paid on the common shares held by the family trust and allocated to Max, who is now operating the family farm, will be taxed at his normal marginal tax rate. But dividends which are allocated to his sister Katie, will be taxed at the flat rate of approximately 45% because she has no involvement with the farm. This is particularly problematic because Katie has taken a leave from her job as a speech therapist to raise her three children and, as such, is earning virtually no other income.

Death

Fast forwarding again, at the age of seventy-five, Ben dies. Under his will, Ben's remaining shares in the family farm company are transferred to Sally. This occurs without tax consequence. However, when Sally dies three years later holding the remaining shares in the family farm corporation, she is deemed to have disposed of the shares at an amount equal to their fair market value immediately before death and her estate is deemed to have acquired the shares at the same fair market value. If half of the shares which Ben and Sally held have been redeemed, that means there will be a deemed disposition of the remaining shares which she holds at their fair market value--$500,000 in this example. Since the cost base is nominal, we assume the gain is $500,000.

Implications of Proposed Amendments:

Since Sally was never active in the farming business, as a result of her death, a flat rate of tax of 45% will be payable on the full fair market value of the shares which she owned at death--$500,000 (which is treated as ordinary income). The shares of the family farm company owned by Sally immediately before her death will then fall into her estate.

Sally's estate then has to come up with the funds to pay the 45% tax on $500,000. Sally's estate may redeem the $500,000 of shares, giving rise to a dividend in the amount of $500,000. Tax on this dividend is payable at a flat rate of 45%.

So, although Sally held shares of the family farm company with a fair market value of $500,000 at her death, after paying the income taxes owing by virtue of the proposed amendments, Sally's estate will have $50,000 remaining after tax (tax of $450,000 will have been paid on shares with a fair market value of $500,000 on Sally's death). The Government is taxing the same amount twice.

Under the existing tax rules, Sally would realize a taxable capital gain of $250,000 on the deemed disposition of her shares in the family farm company on her death. Under the existing rules, Sally's estate would realize a capital loss in the amount of $500,000 on the redemption of the shares in the family farm company. Sally's estate would apply the capital loss against the capital gain. The proposed amendments eliminate this standard planning by deeming the $250,000 taxable capital gain otherwise realized on the deemed disposition of Sally's shares on her death to be $500,000 of ordinary income, because Sally was not active in the farming business.

Can the double tax result be avoided if the Government's proposed amendments to the *Income Tax Act* are enacted? The answer is yes, if Sally's estate, Max and Katie are prepared to sell the family farm. Under the proposed amendments, if Sally's estate sells the shares of the family farm company which it owns to an unrelated, arm's length person, a significantly better tax result occurs. Realistically, however, no other farmer is going to want to buy only Sally's shares of the family farm company. A farmer is going to want to buy <u>all</u> of the shares of the family farm company (including those held by the family trust). But, if

the family trust sells its shares of the family farm company, Max has lost his job and source of income.

So, the decision becomes:

1. does Sally's estate take the enormous income tax hit so that the farm can stay in the family; or

2. is the family farm sold so that considerably less income tax is paid?

Even if the shares of the family farm company are sold, under the proposed amendments, Katie cannot claim the capital gains exemption on the disposition of her portion of the shares of the family farm company because she has not been active in the farming business. Thus, Katie takes a tax hit on any taxable capital gain realized on the disposition of her shares, while Max (who has been active in the farming business) can claim the exemption for some or all of the taxable capital gain he realizes on the sale of his shares.

Finally, if Sally's estate pays the $450,000 of income tax on shares worth $500,000, as the proposed amendments will require if enacted, and the farm remains in the family, assuming Max continues to farm and the tax laws do not change, the same punitive tax measures will apply when Max retires from farming and subsequently dies.

Conclusion

If the proposed amendments to the *Income Tax Act* with respect to private corporations are enacted into law, owners of family farms will be operating in a new tax environment which does not reflect the inherent risks of the farming business, or the realities of the contributions, or sacrifices made by spouses on farms. If enacted, the proposed amendments also do not encourage succession in family farms. Structures put into place as part of tax planning years ago, may still be impacted by the proposed amendments, if they are enacted.

Although this article has focused on farming, the tax implications described above regarding the application of the Government's proposed amendments to the *Income Tax Act* will be felt by private corporations, large and small. Farmers, doctors, plumbers, electricians, lawyers, manufacturers, accountants, the owners of the convenience store, etc. who run their business through a corporation, will almost assuredly be significantly and negatively impacted by the Government's proposed amendments to the *Income Tax Act*.

David Fox is a Partner in the law firm Cummings Cooper Schusheim Berliner LLP, where he practises tax and estate planning law and tax litigtion. David can be reached at dfox@ccsb-law.com.