Tax Planning Strategies: Why Consider Incorporation?

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Owners of family farms may take advantage of fairly simple planning strategies to minimize taxes and to creditor-proof their assets.

Where an individual does not incorporate a family farm business, the $750,000 capital gains exemption is still available to the individual or a family trust upon sale of the business, provided the assets satisfy certain criteria that relate to the type of property, its ownership and use.

More specifically, "qualified farm property" includes shares of a family farm corporation, real property that has been used in the course of carrying on the business of farming in Canada by certain eligible users, certain types of capital property used in the course of carrying on the business of farming, and an interest in a family farm partnership.

Depending on who uses the property, a gross revenue test or a principal use period test must be satisfied (both tests do not have to be met). The "gross revenue test" requires that while the property was owned by an eligible user (other than a family farm corporation) or a trust, the gross revenue of the eligible user (or the trust) from the farming business must have exceeded the income of the user from all other sources for the year. Further, the eligible user (or the beneficiary of the trust) must have been actively engaged on a regular and continuous basis in the farming business (ie, more than 50 per cent of the time).

Alternatively, the "principal use test" is applied where the farm business is owned by a corporation or a partnership. This test requires that throughout a period of at least 24 months, the property must have been used principally (ie, more than 50 per cent of the time) in the course of carrying on a farming business by an eligible user who was actively engaged on a regular and continuous basis in the farming business in which the property was used.

The optimal strategy to ensure eligibility for the capital gains exemption upon the sale of a family farm business and to minimize taxes while still operating the business depends on the facts and circumstances of each particular business. Working with legal, accounting and financial planning advisors can enable businesses to optimize their tax savings and grow their wealth.

This article looks primarily at how incorporation may be used to reduce your family tax burden while you are farming or in retirement, and to make effective use of capital gains provisions through your estate. An article in the next issue of Country Guide will focus more directly on the potential benefits of family trusts. Before selecting any such option, it is important to obtain legal, accounting and financial planning advice for your specific farm and family circumstances.

Individuals who operate their farm business as sole proprietors, or perhaps together with their spouse as a couple in partnership, are taxed personally on all business profits and losses. Where the farm business is earning sufficient income that not all of the annual profits are spent by the owners on personal expenditures, such as to pay down personal debt or to fund daily living expenses, taxes can be minimized by incorporating the farm business.

A Canadian-controlled private corporation carrying on active business is taxed at a significantly lower rate than an individual carrying on the same business. More specifically, the first $500,000 of business profits of an active business is eligible for the small business deduction, which applies a tax rate of 11 per cent, as opposed to an individual earning $500,000 in business profits who is taxed at the rate of 46.4 per cent.

Incorporating a family farm business also offers opportunities to structure a corporation that is owned by various family members, even if they are not employed in the business. By including lower-income earning spouses and adult children as shareholders of the corporation, each of whom own a different class of shares of the corporation, the corporation can pay dividend income to family members in differing amounts on an annual basis so as to "sprinkle" corporate profits among family members in lower tax brackets.

For example, a shareholder earning no other income may receive $30,000 to $40,000 in dividend income each year on a tax-free basis. This results in a substantial tax savings, as this income would otherwise have been taxed firstly in the hands of the individual business owner (along with all other business profits) at the highest marginal tax rate, requiring the owner to earn $60,000 to $80,000 in pre-tax income for the same after-tax result.

This presents an income-splitting opportunity in family farm businesses where adult children are still financially dependent.

When considering incorporation, owners who carry on their farm business with a spouse or another individual must consider whether it is more advantageous to transfer their assets into a new corporation personally, or instead to transfer their partnership interest into the new corporation.

This analysis includes a review of the accounting treatment of the business and the tax attributes of the farm assets. Accordingly, clients are encouraged to consult with their accounting and legal advisers before making this determination, as significant negative tax consequences may result if an incorrect decision is made.

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While care is taken to ensure the accuracy for the purposes stated, before relying upon these articles, you should seek and be guided by legal advice based on your specific circumstances. We would be pleased to provide you with our assistance on any of the issues raised in these articles.

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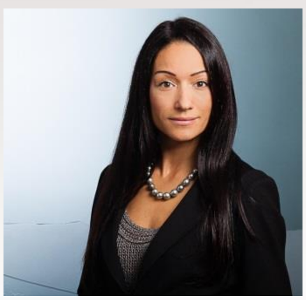

Leilani's practice is focused on corporate and commercial transactions, including mergers, acquisitions and securities matters, with a primary focus on owner-manager taxation issues, corporate reorganizations, estate planning, trusts and commodity tax issues. Leilani's practice includes charities and non-profit organizations.