Ontario Federation of Agriculture

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September 29, 2017

The Honourable Bill Morneau, MP
Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, ON
K1A 0G5

Dear Minister Morneau,

Re: Tax Planning Using Private Corporations

The Ontario Federation of Agriculture (OFA) is Canada's largest voluntary general farm organization, representing more than 36,000 farm family businesses across Ontario. These farm businesses form the backbone of a robust food system and rural communities with the potential to drive the Ontario economy forward.

25% of all farm businesses in Ontario and Canada have chosen to incorporate their business. incorporated farm businesses are mostly family owned. The term 'corporate' has no bearing on the size or type of farm.

Farmers are not the "1%" and do not avoid paying their fair share of taxes through "loop holes", as the wording in the July 18th consultation document suggests. Farmers simply want to be able run a family business which includes **compensating family members for their contributions**, and passing down the legacy of the family farm to the next generation, **without paying double the amount of tax** that they would pay if they sold the farm to a stranger.

If the intent of these proposed changes is to ensure the "1%" pay their fair share of taxes, the department of finance needs to consider alternative methods. These proposed changes will dramatically increase the level of complexity for business owners to file their taxes. The largest businesses, with the most resources to hire high paid tax advisors will be best able to navigate these complexities and as a result will have the "softest landing". Farm businesses and other small businesses in rural areas and do not have the access or the resources to hire the same tax advisors as large urban based businesses. As a result, farmers and rural based businesses will be least equipped to navigate these new complexities.

These proposals could severely limit the ability to compensate younger farm family members from receiving fair compensation for their contributions to family farm and will severely limit their ability to use the Lifetime Capital Gains Exemption (LCGE). These proposals show a clear age discrimination and presume that a 17-year-old does not provide legitimate contributions to the family farm.

Many industry associations have expressed concern over the proposed changes, but we must bring to your attention the disproportionate impact that these changes will have on the Canadian agricultural sector.

Maintaining the Tradition of the Canadian Family Farm

Ontario and Canada have a long tradition of family farms that have been passed down through many generations. These family farms have acted as excellent stewards of the land and have made critical contributions to the Canadian economy. Maintaining the model of the Canadian family farm is critical for Canada's environmental and economic well being.

After consulting with several national accounting firms, OFA is extremely concerned about the impact these proposals will have on farm succession planning and intergenerational transfers of family farm businesses.

Most of the value of farm businesses in Canada is derived from land and capital. The right to have that capital taxed as a capital gain and the ability to use the Lifetime Capital Gains Exemption (LCGE) for qualified farm property is a pillar of farm succession planning and necessary to ensure the farm can be handed down to the next generation without compromising the retirement and financial stability of the current generation.

Regarding the LCGE, OFA is extremely concerned with the proposed introduction of subsection 110.6(12) under the Income Tax Act (ITA). Most damaging of the proposed restrictions of the LCGE would be the restriction on gains accruing or realized before the age of 18 years.

As mentioned above, most of the value of farm businesses is derived from land and other capital, limiting the next generation of farmers from using the LCGE for any value that accrued during the first 18 years of their life will add significant tax and compliance costs to future farm family succession plans.

Even more troubling is the unrealistic compliance burden that is placed on farmers that will arise from these proposed changes. If a farmer's children are not allowed to use their LCGE for the gains accrued on qualified farm property prior to that child's 18th birthday, how are farm families expected to determine which portion of the capital gain accrued prior to a child's 18th birthday and after? Is the intent of this proposal to force a farmer to have a full appraisal of his or her qualified farm property on the day each child is born and then again on the day each child turns 18? The level of complexity and costs this will add to family farm succession plans is unacceptable.

Additionally, the proposed amendments of subsection 104(21.2) which restrict the LCGE for gains of qualified farm property that accrued inside a trust will add significant tax costs for intergenerational transfers of the family farm, many of which use a trust to implement that transfer.

These proposals limiting the LCGE must be removed or at the very least their must be an exemption for qualified farm property.

If any child uses the 2018 special election and uses their LCGE in 2018, they will almost certainly pay Alternative Minimum Tax (AMT). This will create a significant tax liability at a time when income is generally insufficient to cover it. While AMT is refundable, this requires sufficient taxable income over the next 7 years. This is particularly unlikely for those going to school, or in the first several years of operating a farm business.

OFA

OFA is extremely concerned with the impact of the proposed changes surrounding section 84.1. The stated purpose of these changes is to address the issue of “surplus stripping”, while the practical application of these changes has a far greater reach and will increase complexity and tax costs for middle class farmers to transfer their farm business to the next generation.

The case study in Appendix 1 illustrates how these proposed changes can more than double the tax bill of a farmer who wants to transfer his farm business to his two children rather than a foreign corporation. Creating this strong financial incentive to sell to 3rd parties creates a disincentive for farmers to keep the farm business inside the family.

How is it fair that sale to family members should be subject to more than double the tax compared to a sale to a 3rd party? Surely the tax rules should help facilitate the tradition of the Canadian family farm rather than jeopardize it.

These proposals as currently worded will jeopardize the tradition of the Canadian family farm and must be removed or at the very least their must be an exemption for qualified farm property.

OFA is pleased that the July 18th consultation document requests feedback on how it would be possible to better accommodate *genuine* intergenerational business transfers. However, the proposed conditions that would need to be met to consider a transfer *genuine,* is unrealistic and would set up the next generation of farmers for failure.

The following requirements is what is suggested in the consultation document to constitute a *genuine* business transfer:

- The vendor ceasing on the transfer to have factual and legal control of the transferred business;
- The intent of the new owner to continue the business as a going concern long after its purchase;
- The vendor not having any financial interest in the transferred business; and
- The vendor not participating in the management and operations of the business.”

The succession and transfer of a farm business from one generation to the next is not something that happens overnight. The process of transferring managerial and financial ownership of a farm business is a process that takes place gradually, and can take place over number of years.

The proposed criteria would force a farmer transferring the business to his or her children to not have any financial interest in the business or provide and advice on how to manage the farm. Under these proposals very few farm succession plans would be considered *genuine*.

If the government is interested in a proposal that would help facilitate *genuine* transfers of farm businesses from one generation to the next, OFA strongly recommends adopting the policy that was proposed in Bill C-274.

The proposed changes in Bill C-274 would remove major financial disincentives for Canadian farmers to transfer the shares of their farming corporations to their children. This is done by amending 84.1(2) of the ITA to deem that the buyer and seller of family farm corporation shares to be dealing at arm’s length if the purchaser corporation is controlled by a child of the seller AND; The purchaser corporation does not dispose of the subject shares within 60 months of their purchase

The proposed amendments in Bill C-274 would help facilitate the transfer of incorporated farm businesses to the next generation, and the requirement that the purchaser not dispose of the subject shares within 60 months ensures that only *genuine* transfers would benefit from these changes.

To help facilitate genuine transfers of farm businesses from one generation to the next, the proposed criteria in the July 18th consultation document must be removed and the suggested amendments to the ITA outlined in Bill C-274 should be adopted.

Fair Compensation for Family Contributions

A farm business truly is a family business. That means that different family members will pitch in and provide labour at different points in the production cycle. Farmers are confident that the labour provided by family members is reasonable. However, OFA is concerned with the vague wording of the proposed "reasonableness test" for family members earning wages from the farm corporation. Of concern is the wording for the reasonableness test for those family members aged 18-24 which states that the family member must be engaged on a "**regular, continuous, and substantial basis**"

The phrasing of "continuous" is particularly concerning for farmers. Many of the children of farm business owners who fall in the 18-24 age range are away at school, often studying a discipline related to agriculture and business management, with the intention of applying what they learn back on the farm. Many of these same children will return to the farm to help with harvest and other busy times on the farm where extra help is required. These labour contributions are not only reasonable, but are often vital to ensure a successful harvest, and they should be compensated for that contribution to the farm.

OFA urges the government to clarify the vague language proposed under the "reasonableness test" to ensure that reasonable contributions to the farm business receive reasonable compensation. Farm families should not be penalized for sending the next generation of Canadian farmers to school so that they can acquire the skills necessary to lead the Canadian farm sector into the future.

Passive Investment Proposals

The July 18th consultation document states that incorporated businesses have an unfair advantage for investing in passive investments. This is since the tax rate for business income earned by private corporations (15% or 26.5% in Ontario) is lower than personal tax rates (top marginal tax rate in Ontario is 53.5%). This lower tax rate on business income leaves more after-tax income to be invested in passive investments compared to a salaried employee.

The income derived from passive investments is already subject to taxation near 50%, which approximates the top personal marginal tax rate. OFA has no issue with the current treatment of income derived from passive investments, as the lower corporate tax rates should be used to allocate additional funds to meet needs of the business.

The proposal to increase tax on the initial funds contributed towards that passive investment will restrict funds that are needed to meet many of the needs of the farm business. Most funds that farm business owners contribute to passive investments are short term in nature. These funds are often earmarked for emergencies such as a barn fire or to be eventually invested back into the business, such as saving to purchase additional land or machinery to help expand the farm business.

Further, farmers often experience cash flow issues as many of them receive the bulk of their income during a particular time of the year. **Putting surplus revenue away into short term investments to manage financial risk is good management and should not be penalized**.

A serious concern, that is specific to farmers, is how these proposals related to passive investments would impact contributions to Agri-Invest accounts held inside a family farm corporation.

The stated purpose of the Agri-Invest program by Agriculture and Agri-Food Canada (AAFC) is to "help you (farmers) manage small income declines, and provides support for investments to mitigate risks or improve market income". Agri-Invest is a key pillar in the suite of Business Risk Management (BRM) programs available to Canadian farmers. However, functionally an Agri-Invest account is simply an interest accruing account held inside a financial institution, in other words a "passive investment". **Is it the governments intention to increase the tax applied to Agri-Invest accounts held inside a family farm corporation**? This would place farm businesses that have chosen to incorporate at an unfair disadvantage compared to non-incorporated farmers.

Given the impacts these proposals would have on ability for farmers to manage financial risk, and given the increased complexity and cost of compliance that would result**, the proposals surrounding passive investment income, as currently worded in the July 18th consultation documents must be removed.**

Finally, a comment on the way this consultation was conducted. A 75-day consultation that wraps up during the busiest time of the year for most farmers, does not provide opportunity for farmers to get up to speed on these complex proposals and engage in a conversation. Farmers are not the "1%" and do not appreciate being labelled as tax cheats using "loop holes" because they decided to incorporate their family farm business and implement planning strategies that have been accepted and used for decades.

If reform of the corporate tax system is a priority of this government, it should be done by working with small businesses and farm businesses to find workable solutions. As currently worded OFA cannot support these proposed changes. These proposals must not move forward. OFA is happy to participate in a genuine consultation on the corporate tax system in the future and looks forward to the opportunity to work with government to find workable solutions.

Sincerely,

Keith Currie
President

Appendix 1- Impact of Proposed Changes on Farm Succession

Many years ago, John established Farm Business “A” Inc. In Ontario. The business has expanded significantly over the years. John has two children, George and Jane who are both actively involved in the farm business. However, they are not shareholders.

John will soon be 75 years old, and he wants to pass the farm business to his children. Over the decades, john reinvested everything back into the farm and this will serve and his retirement fund. The shares of the business have been valued at $4 million, and he would like to work out an arrangement where George and Jane can purchase the business and pay him over time from the earnings of the business.

John knows from speaking with his advisors that any amount which he claims under the capital gains exemption cannot be paid out from the business in this way, but that is only $1 million out of the $4 million. He is willing to forgo claiming the capital gains exemption in order to keep the farm in the family.

John is now at the point where he wishes to go ahead with a succession plan and seeks professional advice on how to structure the plan.

The original plan was to sell the shares to George and Jane for notes to be paid over 5 years. They would transfer the shares to holding companies (GCo and JCo) for notes. These holding companies would receive dividends from Farm Business “A” Inc. and then pay George and Jane. John would realize a capital gain of $4 million. Income would be earned each year by Farm Business “A” Inc., corporate tax would be paid, and the remainder would go to dividends to GCo and JCo and ultimately to John. He anticipates he will pay tax on the capital gain at about 27%, which he is prepared to do. Additionally, the gain will be taxed over 5 years, helping to match the tax to what he will receive. This 5 year period is a special incentive to help transition a family farm business to the next generation

Under Proposed Rules

John is advised that under the proposed rules, there is a problem with his succession plan. When George and Jane put the shares into their holding companies for notes, they will now be deemed to receive dividends. John may be taxed as well on the capital gain on sale (which could be recharacterized as a dividend, however this is unclear). But what is clear is that the best position is that one dividend results.

At minimum, tax of approximately 45% is to be expected on the dividend, all payable in the year of sale.

The plan to transition the farm business has risks, if the farm business fails, John’s retirement fund is in Jeopardy.

John is advised that these adverse taxes are result of the new proposed rules and how they will apply where the business is being sold to family members. Alternatively, if John sells the farm business to Mega Investment Corp, a foreign investment company with operations in Canada, he will not only be able to realize a capital gain as he originally planned, but will also be able to claim the capital gains exemption on $1,000,000 of the capital gain. Also, John takes zero risk in this option.

In the best-case scenario, the tax paid on a transfer to the children is approximately **$1,800,000** (45% of $4 million).

The tax paid on sale to Mega Investment Corp is $810,000, which is less than half the tax and almost a $1 million less than if he transferred the business down to his children. This is because a capital gains exemption of $1,000,000 can be used and the remaining $3,000,000 is taxed as a capital gain at 27% ($3,000,000 x 27%=$810,000).

With such a strong financial incentive which is risk free, why would George not proceed with a sale to Mega Investment Corp?

How is it fair that sale to family members should be subject to more than double the tax compared to a sale to a 3rd party? Surely the tax rules should help facilitate the tradition of the Canadian family farm rather than jeopardize it.

Appendix 2- Summary of Recommendations

Limiting of the Lifetime Capital Gains Exemption (LCGE)

Exempt qualified farm property from the proposed limitations on the LCGE regarding:

1.) gains accruing or realized before the age of 18; and
2.) gains accrued within a family trust

Income Sprinkling

- Clarify the vague language proposed under the "reasonableness test" to ensure that reasonable contributions to the farm business receive reasonable compensation.

Passive Investments

- Clarify that AgriInvest funds and farmland rental income be considered active business income.
- Any proposals addressing passive investments must recognize the range of legitimate business uses for passive investment income without creating additional, punitive tax liabilities.

Converting Income into Capital Gains

- The proposed measures to address converting income into capital gains will have unintended consequences on genuine farm succession plans. As currently worded, these proposed changes must not move forward and at the least their must be an exemption for qualified farm property.

Encouraging Genuine Intergenerational transfers of incorporated farm businesses

- To help facilitate genuine transfers of farm businesses from one generation to the next, the proposed criteria in the July 18th consultation document must be removed and the suggested amendments to the ITA outlined in Bill C-274 should be adopted.