A Primer to Understanding Farm Income

Prepared for: Legal Education Society of Alberta

Reading Tax Returns and Corporate Financial Statements

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For presentation in:

Edmonton, Alberta – December 1, 2015

Calgary, Alberta – December 8, 2015

A PRIMER TO UNDERSTANDING FARM INCOME

INTRO

When I was a junior lawyer, my blood would run cold when confronted with a file that involved farm income. Farm income reflected in tax filings is notoriously unreliable for use in addressing child support and spousal support claims. It is natural to expect that the determination of an appropriate deemed income would involve a daunting analysis of personal income tax returns; a critical review of statements of business and farming activities, and income sources; and a cynical examination of the various available deductions from income; and winnowing out expenses and deductions that ought to be added back to personal income.

While this process is detailed, it is not as daunting as one might expect. The following discussion is intended to help understand what to look for, in order that questions that may arise can be the subject of further examination, and reconciliation by the farm accountant, or an independent expert retained on your behalf.

FARM CORPORATIONS, SOLE PROPRIETORSHIPS, AND HOBBY FARMS

FARMING CORPORATIONS

Many farms, particularly those that are larger and more sophisticated, restructure their farm business into a farm corporation.

The main benefits in doing so are:

- Providing a tax deferral and a lower tax rate of 15.5% on the first $400,000 of active business income, as opposed to rates up to 44% that similar income would attract personally.
- The ability to control the amount of income that may be removed from the corporation so that you are taxed at a lower rate than if the income were received personally.
- You can pay down debt in the corporation using income tax at the corporate rate, as opposed to paying down debt personally using income tax at a higher rate.
- You can take advantage of the capital gains deduction when transferring a qualifying farm partnership into the corporation, giving you a substantial shareholders loan that allows you to take funds out of the company tax-free.

The shareholders of the corporation may be the farmer solely, or multiple family members. It is important to examine the structure of the corporation and to categorize the transfer of funds out of the corporation. Consider:

- Some payments may be made to retiring parents, as payment for their transfer of farm assets.
- Funds may be paid out legitimately as a salary for labour on the farm, or as dividends to owners not directly involved in the corporation.
- Funds may be dividended to family members to take advantage of their lower tax brackets.

SOLE PROPRIETORSHIP FARMS

Many farmers conduct their farming business as their chief source of income. The majority of their time is spent on the farming operation, and there is continuing development, investment and expansion of the farm consistent with available resources.

In other cases, however, while the farmer may spend a significant amount of time on the farming operation, it is an adjunct to other employment income generated from trucking or some other complementary pursuit. Under such circumstances, it is possible to apply farming losses against other income sources.

The farming income is simply reflected in the farmer's T1 General Return.

HOBBY FARMS

A hobby farm is a farming operation from which there is no reasonable expectation of profit. The presumption is that the property is being held for personal use or enjoyment of the individual, and no losses are deductible whatsoever.

Sometimes it is difficult to determine whether a farm is a hobby farm or simply a consistently unprofitable business.

In the past, in order to write-off all farm expense, proof was required that farming was the "chief source of income or predominant source of income in combination with another source". As a result of a recent interpretation, the farming only has to be a "significant endeavour" to be entitled to write-off all of the losses. This involves not only an expectation of profit, but a consideration of the amount

of time spent on the farming operation, and the degree of investment and expansion of the farm from available resources.

If the farm has a reasonable expectation of profit, but does not pass the "significant endeavour test", then the losses will be restricted to the first $2500 plus 50% of the loss over $2500 up to a maximum of $8,750. The losses over this limit will carry forward up to twenty (20) years or back three (3) years to be used only against farming income.

Regardless of the form the farming operation takes, your "big picture" objective remains the same:

1. Identify the sources and amount of revenue;
2. Determine the allowable or legitimate business expenses; and
3. Identify possible personal benefits to the farmer (other than personal income) that ought to be added back to his disposal income.

SOURCE AND LEVELS OF INCOME

The revenue sources for the farming operation will typically include crop or livestock sales, but may also be diversified to include oil and gas leases or royalties, leasing of farm equipment or land, or farm services such as, custom seeding, spraying or combining.

It is important to analyze the sources of income and the income levels over a sustained period of three (3) or more years. This will allow you to identify changes in revenue sources; and fluctuations of income.

Decreases in income may be the result of market fluctuations, farm disaster or crop losses, or something unique to this farm operation.

Conversely, increases in income can result from unusually high crop or livestock yields; positive changes in market prices, the sale of land or the restructuring of the farming business that attracts a large capital gain.

Tax filings will often include income received from farm programs. Some farmers participate in programs offered by the Agricultural Financial Services Corporation (AFSC). AFSC is a provincial crown corporation, whose programs enable participating farmers to receive compensation for specific losses, or to even out income. These include: