

FARM INCOME & LOSSES

Farming is a very diverse and specialized industry in Canada. It encompasses a wide range of activities, including tilling the soil, livestock raising or showing, tree farming, beekeeping and, in some instances, activities associated with raising fish, such as commercial shellfish.

DETERMINING WHETHER FARMING CONSTITUTES THE MAIN SOURCE OF INCOME

The CRA may take several factors into consideration when determining whether taxpayers engage in farming activities to the extent that it constitutes their chief source of income. Taxpayers for whom farming does not represent their main source of income will be limited in their ability to deduct farm-related expenses.

The criteria used by the CRA to examine this issue include:

- Whether or not the farming operation has a reasonable expectation of profit, although as a result of recent court cases, less reliance is stressed on this point;
- Whether earned profits are substantial compared to the taxpayer's major source of income;
- Whether there is a family history of farming activities;
- The extent of the taxpayer's knowledge of farming;
- Whether the activity generating the taxpayer's major source of income has, to some degree, been subordinated as a result of farming activities; and
- The professionalism of business activities, including the existence of a business plan and the amount of time and capital committed.

RESTRICTED LOSSES

Taxpayers who are deemed by the CRA to be engaged in farming activities, but for whom farming is not their chief source of income, will be restricted in any loss they can claim against other income. That claim is limited to the first \$2,500 of farm losses, plus one-half of the next \$12,500 of such losses, for a maximum claim of \$8,750 in one year. Any loss in excess of that claim is identified as a "restricted farm loss" which can be carried back up to three years, or forward up to ten years, and applied against farming income.

Farmers cannot use restricted farm losses to create or increase a capital loss on the sale of farmland. However, any portion of outstanding restricted farm losses may be added to the adjusted cost-base (ACB) of farm property in order to reduce the capital gain realized upon disposition. The allowable portion of such losses applied is limited to the property taxes and interest on money borrowed to purchase land.

A full-time farmer who has to take an outside job to support the farm should be able to claim all the farm losses for tax purposes without application of the restricted farm loss rules.

METHOD OF ACCOUNTING

To accommodate the diversity of farming, there are a number of accounting and income tax provisions available.

Farmers and fishermen have the option of reporting income using the cash (rather than the accrual) method of accounting. The cash method can be advantageous to farmers because it allows them to decide when to report income by timing the sale of produce or livestock in the most appropriate year. Using the cash method, farmers can time expenses by paying accounts in the year they wish to make the deduction.

This timing option, which is not available to members of any other industry, can greatly increase tax-planning alternatives for the farming community.

Tilling, clearing and leveling of farmland, as well as the building of an unpaved road, can be expensed in the year such payments are made, or any portion carried forward to future years. However, land improvements on farmland rented out to another producer do not qualify for this deferral. In such cases, land improvements can be expensed in the current year or, alternatively, added to the cost of the land.

Other differences include:

- Assets purchased during the year are restricted by the CCA half-year rule, except assets such as quotas (which are eligible capital property), where the full amortization amount is allowed in the year of acquisition;
- Deceased farmers' Rights and Things include harvested crops, livestock on hand (less the basic herd), supplies on hand, inventory and receivables (if the deceased used the cash basis of accounting); and
- No GST is charged on sales of most farm commodities. Registered farmers must, however, charge GST on items such as land and quota rentals and firewood sales that do not fall under the exception list provided by the CRA. Asset purchases and sales specifically exempt include tractors over 60 KW and most harvesting, tillage, haying and grain-handling equipment. Consult the list for further details.

If the farmer is actively involved in peripheral activities, such as the purchase and sale of seed, this business is not considered farming and must be reported using the accrual method of accounting, which will include the reflection of inventories on hand at year-end. The CRA will consider certain non-farming activities to be part of the farming operation if these activities are undertaken on a small scale and the income is incidental to other farming revenue.

Farmers and fishermen should also be aware that:

- Payments received out of the Agricultural Income Disaster Assistance (AIDA) and the Canadian Agriculture Income Stabilization (CAIS) programs are taxable when received; and
- Advance payments for a crop are considered to be a sale of the crop and are, therefore, taxable when received. However, advances under the *Agricultural Marketing Programs Act* (AMPA), are considered loans and are not taxable when received. Income is triggered when the crop is sold and the loan repaid.

MANDATORY INVENTORY ADJUSTMENT (MIA)

Whenever cash-basis accounting results in a farming loss, a mandatory inventory adjustment (MIA) must be performed with respect to purchased inventory on hand at year-end. The MIA is calculated by adding to income the lesser of the loss amount and FMV of the purchased inventory, such as livestock, feed, fertilizer, fuel, and other supplies on hand.

OPTIONAL INVENTORY ADJUSTMENT (OIA)

Farmers can elect to report an optional-inventory adjustment (OIA) at year-end to help reduce wide swings in net income that sometimes occur under the cash basis of accounting. The OIA is calculated on an individual, rather than a partnership, basis. Using the OIA, the taxpayer may elect to decrease expenses by an amount up to the full FMV of inventory on hand at year-end. The OIA claimed in one year then becomes an increase in expenses the following year.

SALE OF TIMBER

The sale of standing timber is considered to be a sale of qualified farming property (QFP) as long as it is incidental to the farming operations. To be classified as QFP, the property must be on a farm, combined with a farming business, with revenue from that being infrequent and insignificant in relation to the gross income from total farming operations.

The sale of standing timber is reported as a sale of QFP and as such would be filed as a capital gain that qualifies for the enhanced \$500,000 capital-gains exemption. If on the other hand, the farmer cuts down the trees himself and sells the logs or firewood, it would result in earned income from farming and be taxed accordingly.

An interpretation bulletin from the CRA states that the farmer must not have purchased that property with the intention of selling the timber. Furthermore, the agreement must be an isolated transaction, with the price paid being a fixed amount (i.e., not determined based on cubic metre, board feet, etc.).

The timber must also be removed over a short period of time, generally less than six months.

Note also that a farmer who plants an orchard must capitalize the cost of the trees by adding it to the adjusted cost base (ACB) of the land. Therefore, those trees would not qualify for capital-cost allowance (CCA). However, replacement trees can be expensed in the current year.

SALE OF SAND, GRAVEL AND TOPSOIL

The CRA continues to treat the sale of sand, gravel and topsoil as farming income when it is removed from the farmland of a taxpayer who is actively engaged in the business of farming.

INVESTMENT TAX CREDIT

A Scientific Research and Experimental Development (SR&ED) investment tax credit may be claimed on that portion of the farmer's "checkoff," "assessment," or "levy" that is used for SR&ED by the commodity boards. Individuals qualify for a 20 per cent investment tax credit on the amount that is considered by, for example, the wheat and corn boards, as being applicable to SR&ED expenditures. The boards then usually issue a statement or letter to the producer identifying the proper amount to claim.

FARM DISPOSITIONS AND CAPITAL GAINS

Farm property dispositions may qualify for the \$500,000 capital-gains deduction subject to certain restrictions. If, for example, the farm was purchased before June 18, 1987, the property must have been used principally in a farming business during at least five years that it was owned by the taxpayer or his/her ancestors.

If the farm was purchased after June 17, 1987, the taxpayer must have owned it for at least 24 months and the gross revenue from farming must have exceeded income from all other sources for at least that 24-month period. A farmer who acquired the farm before June 18, 1987 but made the election available in 1994 to report accrued capital gains on the farm was deemed, in that year, to have disposed of that property and reacquired it at the proceeds of disposition designated in that election. This "deemed reacquisition" means he/she must now follow the rules applicable to farms acquired after June 17, 1987.

A farmer is permitted to claim a reserve on that portion of the farm sale that is not yet payable, according to certain restrictions. If the farm is sold and a mortgage taken back from the purchaser, the vendor must report capital gains on the greater of: 20 per cent of the gain each year, or the amount of proceeds received. This can spread the tax from that capital over a period of up to five years. For a non-arm's length sale, from a parent to a child for example, the minimum amount changes from 20 per cent to 10 per cent of the gain and enables the vendors to effectively spread the tax over a period of up to 10 years.

The alternative minimum tax (AMT) does not apply to the capital gain on the sale of eligible capital property (quota, for example). Nor does the AMT apply to any deemed dispositions in the year of death.

There are special rules for transferring farmland, eligible capital property and depreciable property of a prescribed class to a spouse/common-law partner or child during a taxpayer's lifetime or upon his/her death.

There are specific rules that relate to the transfer of farmland in Ontario. Currently, for example, all transfers of farmland made into a family-farm corporation are exempt from land-transfer tax (LTT). The Ontario government has expanded this provision to include qualified transfers of farmland between family members.

ONTARIO RETAIL SALES TAX

Farm implements, machinery and equipment designed for farm use, such as tractors, milking machines, farm wagons, etc., can be purchased without Ontario retail sales tax by persons in the business of farming. Repairs to these items also qualify for exemption. A purchase-exemption certificate must be signed and given to suppliers on items that are not generally made exclusively for farming use, such as fertilizers, pesticides and hand tools.

There is a point-of-sale exemption for the purchase of farm building materials. For more information contact your local Retail Sales Tax Office.

OTHER MEASURES

1. CANADIAN AGRICULTURAL INCOME STABILIZATION PROGRAM (CAIS)

The Canadian Agricultural Income Stabilization (CAIS) Program is designed to provide Canadian agricultural producers with a long-term whole-farm risk-management tool that provides protection for farming operations from both large and small declines in farm income.

For details about the CAIS program, consult the CAIS Handbook; call CAIS at 1-877-838-5144; contact the Ontario Ministry of Agriculture, Food and Rural Affairs; or consult with a certified general accountant who is familiar with this program.

2. CROP ADVANCES

Farmers are eligible for up to \$50,000 in interest-free cash advances for stored crops under the *Agricultural Marketing Programs Act*. Advances of up to \$250,000 are also available at market interest rates. The crop must be in storage in a non-processed form, while the producer must retain title to the crop and also be responsible for marketing it. This advance is considered a loan and is not taxable when received. Income is triggered when the crop is sold and the loan repaid.

3. CANADIAN FARM BUSINESS ADVISORY SERVICES (CFBAS)

A financial-management counseling program, entitled the Canadian Farm Business Advisory Services (CFBAS), is available for Canadian farmers who are experiencing agriculture-related financial problems. For a fee of \$100, farmers can receive confidential counseling services to deal with problems such as decreased margins or cash flow difficulties. Farmers in drought-stricken regions of Canada, which have been particularly prevalent in some venues in recent years, may also qualify for income-tax relief.

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