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FEDERAL TAXATION OF FARMERS: DISCUSSION OF ISSUES

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INTRODUCTION

Farming is part of Canada's cultural heritage, and is closely identified with the economy and the social fabric of rural life. The farming business is overwhelmingly unincorporated and run by families;[(1)] there remains a strong tradition of the family farm, with one generation passing the business to the next.

Farm production is the cultivation of natural resources and is inherently unpredictable. Consequently, sophisticated risk-management programs and practices have been developed to mitigate uncertainty. Where product differentiation is difficult to achieve, farmed commodities are typically generic and farmers rely heavily on reducing costs to stay competitive. For this reason the industry has adopted cooperative structures and regulated markets to gain market power, to a much greater extent than other industries.

Today, more than at any other period in history, the agricultural sector operates in a globally competitive context, which contributes to the structural changes facing agriculture throughout the world. In Canada, there are fewer and fewer farms. Those that remain have grown in size, production capacity and capital intensity to stay competitive.

In recent years, persistently low farm incomes have fuelled talk of a crisis in the farm sector, and questions have been raised as to whether farm returns are adequate to sustain the industry. Farming may not be attracting a younger generation, which is a matter for concern since the majority of farmers today are getting older and will soon retire.

Many special tax measures are available exclusively to farmers. Such measures exist because governments accept that the application of normal tax rules to the farm sector would cause undue hardship.[(2)] Many of these features were introduced early in the development

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(1) Department of Finance, *Tax Issues in Agriculture*, Discussion Paper, Ottawa, January 1985.

(2) D. K. McNair, *Taxation of Farmers and Fishermen*, Richard De Boo Limited, Toronto, 1980.

of the income tax regime.(3) They reflect the unique challenges facing the industry and the larger social benefits associated with agriculture.

This paper will briefly examine and discuss certain policy issues related to federal farm taxation in Canada. It will focus on areas of federal influence, such as income and commodity taxes. Particular attention will be given to income tax issues that are of special significance to farmers, including capital gains, cash accounting and inventory, off-farm income and investment tax credits. A final section will discuss consumption taxes, specifically the Goods and Services Tax (GST) and the federal fuel taxes.

INCOME TAX

Farming income, for income tax purposes, is money earned from the following activities: soil tilling, raising and showing livestock, racehorse maintenance, raising poultry, dairy farming, fur farming, tree farming, fruit farming, beekeeping, operating a feedlot and other related activities. It does not include income earned as an employee in a farming business.(4)

Most farm operations in Canada are unincorporated businesses or partnerships and therefore are subject to personal income tax on their earnings.(5) There are advantages to being unincorporated, such as having access to the capital gains exemption (discussed below), and decreased complexity associated with reporting income. On the other hand, incorporated farm businesses can take advantage of limited liabilities and lower corporate tax rates compared to the personal income tax system. Those lower corporate rates, however, are really a deferral of income tax until the earnings are taken out of the corporation.

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(3) *Ibid*.

(4) Canada Revenue Agency, *Farming Income*, T4003 Rev 05, Ottawa, 2005.

(5) Both the federal and provincial governments (except for Alberta) apply progressive personal income tax rates on different income tax brackets. (Alberta applies a single rate on taxable income.) A full examination of provincial income tax is beyond the scope of this paper. Nonetheless, as most issues raised in this paper concern the determination of personal taxable income, the views presented here relate directly to provincial income tax regimes since all provinces except Quebec apply provincial tax rates to federally defined personal taxable income, and Quebec closely parallels the federal definition of personal taxable income.

A. Capital Gains

A capital gain or loss is the difference between the value of a property when purchased (adjusted to reflect any subsequent property improvements) and the value of the property at time of disposition,[(6)] or in other words when the property's ownership is transferred. If a property owner dies, the person who receives the proceeds of the disposition is deemed to have incurred a capital gain or loss, even though there was no actual sale of property. Capital property transferred to a spouse is not generally subject to capital gain or loss until the spouse subsequently sells the property.

If a capital gain is realized, a portion of this value is subject to income tax. If a capital loss is realized, this value can be used to reduce future or previous capital gains. Currently, 50% of all realized capital gains is subject to income tax. However, there are exceptions, including two that are specific to farming: the lifetime cumulative $500,000 capital gains exemption on the disposition of qualified farm property,[(7)] and the deferral of income tax on capital gain from intergenerational farm transfers.[(8)]

1. Lifetime Exemption of Cumulative Capital Gains

The $500,000 lifetime capital gains exemption for qualifying farm property and shares of small businesses was introduced in the 1985 federal budget. Only individuals can claim the capital gains exemption; incorporated businesses are excluded. Up to $500,000 of capital gains accumulated over an individual's lifetime can be exempted. In the case of a farm family, a spouse is also eligible for the $500,000 exemption, amounting to $1 million in capital gains exemption. If children are involved in the farm business, the exemption can be further increased.[(9)]

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(6) A number of rules are used to establish the actual value of the disposed property for tax purposes. Generally, the initial purchase price is increased to reflect capital improvements; this is called the adjusted cost base (ACB). Also, depreciable properties are subject to recapture provisions, in the event that the property is sold for more than the amount that was assessed as its depreciated value.

(7) Qualified farm property can be shares of capital stock or interest in the farm enterprise, farm land and buildings and farm production quotas.

(8) The capital gains inclusion rate is 50%; therefore, the value of the $500,000 exemption translates to a $250,000 deduction from taxable income.

(9) Alex S. MacNevin, "Agricultural Taxation in Canada: An Overview and Assessment," *Canadian Journal of Agricultural Economics*, Vol. 46, 1997, pp. 93-116.

In general, the capital gains exemption is seen as an incentive for making investments and taking risks. Farming requires substantial capital investment, and many farmers are therefore unable to take full advantage of other types of tax shelters, such as registered retirement savings plans (RRSPs) – hence the logic of giving preferential tax treatment to farm properties. Farmers generally reinvest their revenues into the farm operation, which is the reason why many farmers see their farm properties as their retirement nest egg.(10) The capital gains exemption means that a farmer will retain a larger share of the proceeds from the eventual sale of the farm.

The $500,000 limit on the cumulative lifetime capital gains exemption has not increased since its introduction in 1985, meaning that inflation has caused the real value of the exemption to diminish over time. Inflation also increases taxable capital gains. As a result, there have been many calls to increase the exemption given to farmers.(11)

Alternatively, because farmers generally rely on the capital gains exemption far more than on RRSPs for their retirement income,(12) there have been suggestions that the capital gains exemption could be replaced by a modified tax-assisted retirement measure, similar to RRSPs, that would apply to taxable gains from farm property and would allow cumulative RRSP tax deduction limits equivalent to those provided under the current $500,000 capital gains exemption.(13) It has also been suggested that those tax deduction limits could be increased beyond what would be equivalent under the $500,000 capital gains exemption, in order to reflect the decline in the real value of the exemption since its inception in 1985.

2. Rollover Provision

The tax treatment of capital gains for farmers is an important consideration in farm transfer and succession planning(14) – an issue that has attracted much attention recently, for

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(10) Vijay Jog and Huntley Schaller, "Retirement Income and the Lifetime Capital Gains Exemption: The Case of Qualified Farm Property and Small Business Corporation Shares," *Canadian Public Policy*, Vol. 21, Supplement, November 1995, pp. 136-158.

(11) Edited Hansard, N$^{o.}$ 138, 38th Parliament, 20 October 2005. However, some have raised concerns that increasing the capital gains exemption limit may benefit only a small number of wealthy farm operations.

(12) Jack Mintz and Stephen R. Richardson, *The Lifetime Capital Gains Exemption: An Evaluation*, Department of Finance, 1996.

(13) Department of Finance, *Report of the Technical Committee on Business Taxation*, December 1997.

(14) The lifetime capital gains exemption can be used in conjunction with the rollover provision when transferring farm properties to children. Tax rules require the reporting of capital gains based on the fair market value (FMV) of the property; for example, if a farmer sells property at less than FMV but above the adjusted cost base, the capital gains exemption can be used to help eliminate the tax liability on the resulting capital gain.

several reasons. First, there are fewer younger farmers to replace the older farmers who will soon be retiring. Second, farm asset values have risen, mostly because of the increase in the value of farmland[15] (in most areas) and the growth in the value of farm quotas. At the same time, there has been a steady decline in net real cash farm incomes over the last 20 years.[16]

The high cost of purchasing and operating a farm, and the declining net income it is likely to yield, make farming less attractive to individuals who may be considering it as a career. They also raise concerns about the changing structure of agriculture in Canada. There is a perception that agriculture is moving away from the traditional family farm composition, since many children of farmers may be reconsidering their options. As a result, many rural communities feel that their future is threatened.

In 1972, the federal government introduced taxation of capital gains. Two years later, in 1974 (but retroactive to 1972), the government amended the *Income Tax Act* to provide for the deferral of capital gains tax on farm property transfers to a child. As one analyst has noted, "These amendments recognized the difficulties that would be encountered by farmers in maintaining the tradition of family farm operations if, on the transfer of the farm from one generation to another, a deemed realization took place necessitating the payment of tax."[17]

Specifically, the tax on capital gains on farm property may be postponed if the property is transferred to a child who has been using the property mainly for farming. The types of property that can be rolled over under this provision are farmland, depreciable property and other eligible capital property (quotas).[18] No capital gain is reported until the child sells the property. The tax liability can conceivably be deferred indefinitely if the farm property is continuously transferred to subsequent generations.

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(15) Agriculture and Agri-Food Canada, *Farm Income Data Source Book*, February 2005.

(16) *Ibid*.

(17) McNair (1980).

(18) The purchase cost of depreciable property cannot be deducted from taxable income. However, tax filers can deduct the wear and tear on the property over a number of years. If the property is later sold for more than the depreciated amount, the tax filer is subject to a recapture of depreciation. The rollover provision defers the recapture of depreciation when property is transferred to a child.

The rollover provision and other related measures[19] provide a strong incentive to keep farm property within the family. The overriding goal is the preservation of the family farm structure, which is seen as generating spill-over social benefits, especially in rural regions of the country.

The farming sector is having difficulty attracting young individuals into the profession. There has been concern, therefore, that the rollover provision limits the pool of potential new farmers by excluding those who are not immediately related to the current owner. The lifetime capital gains exemption addresses this concern by alleviating the tax burden on the farmer if the property is sold to a non-family member.[20] Some have advocated expanding the base to which the rollover provision is applied to include other family relations such as uncles and nephews.

B. Cash Accounting and Inventory

Farmers can use either a cash or an accrual method of accounting for the purposes of calculating taxable income. The cash accounting method books cash when it is received, and books expenditures when they are paid. Most other businesses report income based on accrual principles of accounting, which means booking income in the year that it is earned, booking expenditures in the year they are incurred, and reporting inventory valuation changes.

Cash accounting is permitted for farmers in order to accommodate the industry's traditional record-keeping practices.[21] Many farmers prefer the cash method because it offers tax planning advantages and is an easier way to report income.[22] The cash method enables the tax filer to defer income tax payable[23] by deducting from income the cost of inventory in the current year, even if the inventory is still contained within the farm and considered an asset. A

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(19) As an alternative to a tax-free transfer, a farmer is permitted to account 10% of the gain from the disposition of farm property to a child's taxable income every year. Therefore, the farmer can stretch out the taxable capital that must be recognized on the disposition of farm property for a period of 10 years. For most other assets the maximum is 5 years.

(20) MacNevin (1997).

(21) McNair (1980).

(22) MacNevin (1997).

(23) There are a number of other measures designed specifically to provide farmers with options for deferral of income. These measures give farmers more flexibility in reporting farm income for tax purposes. They include the deferral of income due to: livestock destruction; sale of livestock during drought years; grain sold through cash purchase tickets; and a 10-year capital gain reserve.

farmer can deduct from current-year taxes the purchase of inventory intended for the following year. This strategy can be repeated and, in theory, the farmer can continuously defer income taxes. Further, this practice can be used to reduce off-farm taxable income. However, the Canada Revenue Agency (CRA) has put in place mandatory inventory adjustment (MIA) rules to limit the amounts that can be deducted in the event of an income loss position.

The cash method of accounting offers strategic tax planning advantages,[(24)] but is it a good policy? The drawback to this method is that the accounting results do not give an accurate financial picture of the farm. This becomes more important as the farm operation expands and becomes more complex. Financial institutions normally will not lend to farm operations that do not track their financial position using the accrual method. Therefore, many farmers keep two sets of books – which discounts the advantages of using the simpler cash method.[(25)]

The flexibility given to farmers to adopt either the cash or accrual method of accounting stems from the inherent uncertainty of farm revenues, the cyclical nature of the business, and the fact that farmers are usually asset-rich and cash-poor. The cash method has evident benefits for farmers. In the longer term, however, a sustained effort to avoid taxation and to shelter revenues is unproductive. In addition, farmers may be encouraged to strategically purchase inventory at the end of the year in order to defer tax, resulting in possibly less efficient investment decisions.[(26)]

C. Off-farm Income and Restricted Farm Losses

Individuals who make a living farming, and for whom the farm is their chief source of income, and who have a reasonable expectation of profit, can deduct the full amount of net farm losses from all sources of income, including off-farm incomes.[(27)] The ability to deduct net losses from non-farm income is becoming an important feature of the tax system, as more and more farmers rely on non-farm incomes to make ends meet.

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(24) Another advantage is that farmers can add back to their income, on a discretionary basis, the FMV of unsold inventory. This option increases the farmer's ability to tax-plan (add back income during low-income years). Farmers *must*, however, add back the FMV of unsold inventory if their taxable income falls below zero. This is to ensure that farmers cannot reduce off-farm income with these losses.

(25) *Ibid*.

(26) *Ibid*.

(27) Farm losses can be carried forward for ten years or carried back three years.

There is nothing unique about this feature, since other types of businesses can also deduct net business losses from non-business income. What *is* unique is that individuals who carry on farming as a side business with a reasonable expectation of profit, but for whom the farm is *not* their chief source of income, are restricted in the amount of net farm losses they can deduct from off-farm income. This restriction does not apply to other types of businesses.

The allowable deduction for part-time farmers is a maximum of $8,750, which is equivalent to $15,000 in losses.(28) Any losses above $15,000 are considered restricted farm losses, and can be carried forward into future years or carried back into previous years. If a farm operation is not run as a business with a reasonable expectation of profit, then it is considered a hobby farm and net farm losses are not deductible.

The reason for the dissimilar treatment of farm losses stems from a 1977 Supreme Court of Canada decision (*Moldowan* v. *the Queen*) which categorized farmers as either full-time or part-time.(29) Subsequently, the federal government has not moved to reverse the limits placed on part-time farmers, presumably because it wants to limit tax-sheltering behaviour by part-time farmers who may be enticed to take advantage of generous tax incentives afforded to the sector, in order to reduce off-farm income liabilities.(30)

The restrictions placed on part-time farmers, however, may be inappropriate considering that many farm start-ups depend on off-farm incomes and that farmers may not be in a position to make farming a chief source of income.(31) Also, the distinctions between full-time, part-time and hobby farms may not be administratively straightforward to establish, which may result in hobby farms being allowed to claim restricted farm losses for reasons of administrative simplicity.(32) Some have argued that the Canada Revenue Agency should rely on the "reasonable expectation of profit" criterion, as it does for other businesses, and that it should eliminate the restrictions on farm losses.(33)

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(28) The calculation is the lesser of (a) the farming loss for the year; (b) $2,500 plus the lesser of (i) one-half of the amount by which the farming loss for the year exceeds $2,500, and (ii) $6,250.

(29) McNair (1980).

(30) Department of Finance (1985).

(31) *Ibid*.

(32) MacNevin (1997).

(33) *Ibid*.

D. Investment Tax Credits

There are no federal investment tax credits that are specific to the farming sector. However, certain farm expenditures can qualify under existing federal investment tax credits, namely, the Scientific Research and Experimental Development Tax Credit (SR&ED) and the Atlantic Canada Investment Tax Credit (AITC).

1. Scientific Research and Experimental Development Tax Credit

The SR&ED tax credit is designed to encourage research and development. Incorporated Canadian small businesses are given a preferential rate of up to 35% on eligible expenditures, and up to $2 million and 20% on any excess amounts. Large corporations, proprietorships, partnerships and trusts are eligible for a 20% tax credit on eligible expenditures.

Generally, the SR&ED tax credit is considered refundable for incorporated small businesses, meaning the credit is provided even if the business does not have taxable income. Other applicants can use the SR&ED tax credit to reduce federal income tax payable (a smaller portion is refundable). The credit can be carried back three years and carried forward ten years.

It is common practice for farmers to fund agricultural research through a third-party payment mechanism, such as check-offs or levies administered by producer organizations. These producer organizations act as agents through which member farmers can finance eligible research investments. The SR&ED tax credit is then distributed back to individual farmers.

The eligibility of a third-party payment mechanism to receive the SR&ED tax credit is a good fit for the agricultural sector, since very few farm operations would be in position to initiate or fund their own research projects. Also, advances in agricultural research are likely to have spill-over benefits for other farmers (especially those belonging to same commodity sector) and society in general. However, the SR&ED tax credit is much more generous if the business is an incorporated small business. Farmers, by and large, do not tend to incorporate; therefore the tax credit is less well suited to this particular aspect of farming in Canada.

2. Atlantic Canada Investment Tax Credit

The AITC was introduced in 1977 to promote economic development in Atlantic Canada and the Gaspé region.(34) The AITC is 10% and is deductible against federal income tax

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(34) Department of Finance, *Tax Expenditures and Evaluation 2005*, Ottawa, 2005.

payable. The 10% rate is applied to eligible expenditures such as new buildings, machinery and equipment employed in farming, fishing, logging, mining, oil and gas, and manufacturing and processing.

The following AITC-eligible properties are relevant to farmers: capital property such as grain elevators, barns, oil and water storage tanks, tractors, wagons, etc. The AITC is region-specific, presumably because the regions in question have traditionally had low income and high employment. However, there is some question as to the AITC's suitability to creating employment, since the tax credit makes capital more attractive than labour. At any rate, there seems to be no compelling reason not to offer similar tax credits in other regions, especially in Manitoba or Saskatchewan.

CONSUMPTION TAX

A. Goods and Services Tax

The federal GST is a 6% value-added tax applied to the supply of goods and services. A business is required to register to collect the GST and remit it to the government if its annual taxable sales exceed $30,000. A business with taxable sales less than $30,000 is not required to collect the GST, but many voluntarily do, because they are then eligible for refunds (input tax credits) on the GST paid on their business inputs.

Many farm-related items are zero-rated, meaning they are taxable but at a rate of zero. No GST is payable either when they are purchased (inputs) or when they are sold (outputs). Zero-rated items include basic foods such as milk, bread, and vegetables. Many farm inputs are also zero-rated, such as qualifying farm equipment, grain, raw wool, dried tobacco, and most livestock;[35] but some are not, such as crop dusting, road-clearing services, stud or artificial insemination services, the storage of goods (e.g., storing grain in a grain elevator), fertilizer in bulk quantities of less than 500 kilograms, and gravel, stones, rock, soil, and soil additives. The benefit of zero-rated items is that farmers can qualify for a refund of the GST paid on taxable goods and services that were used to produce the item.

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(35) Canada Revenue Agency, *Zero-rated (0%) Goods and Services*, Web site, http://www.cra-arc.gc.ca/tax/business/topics/gst/soleprop/taxable/zerorated-e.html.

The case usually made for zero-rating of GST on farm inputs and outputs is that food is essential, and it makes up a large part of the expenditures of poorer families.[36] This argument is made despite the fact that the GST credit is designed to offset the GST paid by low- to modest-income families, and zero-rating the GST on food benefits all people, not solely low-income families. Nevertheless, zero-rating the GST on food grocery items has wide appeal – it is deeply rooted in the idea that food is a basic necessity. Any notion of levying a tax on food is met with strong resistance, even if the intentions are good. One such example was the many negative responses to a 2005 study by Hugh Maynard and Jacques Nault, which suggested (among other recommendations) levying a sales tax of up to 7% on food to support "economic viability measures for farmers linked to sustainability goals and objectives."[37]

Concerns have been raised about the consolidation of market power of farm input providers. If there is a lack of competitive markets in the farm input sector, it is likely that the full benefits of zero-rating the GST on farm inputs are not being passed up the food chain.

B. Fuel Tax

Fuels used for farming are not exempt from federal excise taxes, nor does the federal government provide a rebate of taxes on those fuels. The federal excise tax on diesel is 4 cents per litre and the tax on gasoline is 10 cents per litre. Recently, the federal government removed the fuel tax on the bio-diesel portion of diesel fuels and the ethanol portion of gasoline fuels.

Prior to 1990, the federal government rebated the federal fuel tax on fuels used in a number of primary sectors, such as agriculture, but those rebates ended when the GST was introduced. The rationale was that input tax credits introduced under the GST offset the sales tax applied to business inputs such as fuel, thereby reducing the tax burden on farmers.

Federal fuel taxes were initially introduced to raise revenue and promote Canada's self-sufficiency in petroleum products[38] – the tax on gasoline was introduced as part of the National Energy Program (NEP) and the tax on diesel was introduced in the mid-1980s.

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(36) MacNevin (1997).

(37) Hugh Maynard and Jacques Nault, *Big Farms, Small Farms: Strategies in Sustainable Agriculture to Fit All Sizes*, Agricultural Institute of Canada, September 2005.

(38) Department of Finance (1997).

Today, the federal government does not link the fuel taxes with the achievement of specific economic and social objectives. In part, however, those taxes can be seen as offsetting the environmental costs associated with fuel production and the construction costs of federally funded highway projects.

Road infrastructure is a provincial responsibility, and most provinces treat their fuel taxes as a road-user tax. This approach is reflected in the exemption of taxes on fuels used for farming equipment, manufacturing and other non-transportation purposes.

The federal government is not directly responsible for most public roads, but it does transfer road infrastructure funding to the provinces. A case can thus be made for removing, or at least reducing, the federal taxes on fuels used for farming and other non-transportation uses of fuels to reflect the fact that these uses do not contribute to the need to repair and maintain public roads.

CONCLUSION

Farming is a unique type of business activity, and this is why the tax system contains measures specific to farms. However, when a tax measure is outdated, or conceived and implemented without sufficient attention to its implications, it may cause more harm than good. It may be useful to reexamine certain tax features to ensure that they reflect the reality of today's farming operations, and to update others to ensure that they are meeting their original policy intent.

The agricultural sector has undergone significant structural changes over the years, and this trend will probably continue. Although revisions to the tax system are unlikely in themselves to alter the direction of the industry, they may be used effectively to alleviate some of the hardship and pressures facing many farmers.