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Tax Treatment of Farm Losses

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Department of Finance Canada
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Introduction

The June 18, 1987 White Paper on tax reform put forward several proposals concerning the tax treatment of farm losses. These proposals provided objective tests for determining the extent to which farm losses could be deducted against other sources of income and proposed new accounting rules for farmers.

The White Paper proposals have been the subject of intensive consultations since June. The consultations have been very useful in pointing out the strengths and the weaknesses of the proposals. Because these consultations are not yet complete the government will not proceed with the tax reform proposals for farmers at this time. However, the government is convinced that changes in the tax treatment of farm losses are necessary. Accordingly, the government proposes modifications of the White Paper proposals for further consultation. Consultations will be held immediately to discuss these modifications, as well as the suggestions set out in the report of the Standing Committee of the House of Commons on Finance and Economic Affairs, in order that legislation may be introduced at an early date.

The purpose of this document is to set out the details of the approach which will be discussed in these consultations, and to provide background information on the current issues surrounding the tax treatment of farm losses.

Reasons for the White Paper Proposals

The White Paper proposals concerning the taxation of farm businesses were introduced for two main reasons. The first involved the concern that the special tax provisions available to farmers might be used more often as a tax shelter mechanism by taxpayers with high off-farm incomes. These special farm provisions include cash basis accounting, the $500,000 capital gains exemption for farm property, the full deductibility of carrying charges on farm land, the deductibility of certain land clearing and improvement costs (e.g. tile drainage) as current expenses and an accelerated capital cost allowance rate for certain types of farm buildings.

The use of these special provisions could result in current farming losses being generated through accounting practices which do not necessarily reflect an economic loss and may be used to reduce off-farm income. The prospect of tax free capital gains in combination with the current accounting and tax treatment has increased the attraction in certain parts of the country of farming as a tax shelter mechanism for high income earners.

As reflected in several recent court decisions, the current law does not restrict the benefit of these special tax provisions only to bona fide farm operations. Because of other tax reform measures which will eliminate many existing tax shelter provisions, the use of farming as a tax shelter could increase significantly to the detriment of the agricultural community. This would call into question existing tax policies for agriculture, and could jeopardize the ability of the government to maintain these tax advantages for farmers. The tax reform proposals concerning farming were introduced both to protect the special tax provisions available to agriculture and to maintain the integrity of the tax system.

The second concern involved the need to resolve the uncertainty that surrounds the rules governing the deductibility of farm losses. Section 31 of the Income Tax Act, which contains the restricted farm loss rules, has been a source of difficulty for many years. These rules restrict the amount of farm losses which may be deducted against other sources of income by taxpayers who are in the business of farming but whose "chief source of income for a taxation year is neither farming nor a combination of farming and some other source". These taxpayers, often referred to as "part-time farmers", are currently restricted to a maximum deduction of $5,000 of farm losses incurred in a year against other sources of income.

Whether a taxpayer is in the business of farming at all depends on whether he or she has a "reasonable expectation of profit" from farming activities. This is the basic test for determining whether any activity -- not just farming -- constitutes a business, where losses are deductible for tax purposes, or only a hobby, in which case the deduction of losses is denied.

Unfortunately, the very subjective nature of the "reasonable expectation of profit" and "chief source of income" tests has made them difficult for farmers to comply with and for Revenue Canada to administer. The White Paper contained a proposal to replace section 31 with objective tests concerning the profitability of the farm (the "profit test") and the source of the taxpayer's income (the "gross revenue test"). These tests would allow farmers who are in a loss position in a year to be certain in that year -- and without concern over the result of a future reassessment based on subjective criteria -- of how much of their farm loss could be deducted in that year against their other sources of income.

To provide greater certainty for start-up farmers, a special application of these tests was proposed to allow qualifying beginning farmers to deduct their start-up costs for the first four years of the farm operation without restriction.

It was further proposed that the calculation of positive farm income should continue to preserve the tax benefit of cash accounting, but that the calculation of farm losses deductible against other income be brought closer to generally accepted accounting principles.

The White Paper Proposals

To achieve these objectives, the following measures were proposed in the White Paper:

- Two objective tests concerning the deductibility of farm losses were to be introduced: the profit test to determine whether any farm loss could be deducted, and the gross revenue test to determine whether the loss would be fully deductible or restricted to a maximum of $15,000.

- Special rules were proposed to relieve qualifying start-up farmers from the requirement to meet the profit and gross revenue tests for the first four years of the farm operation.

- Farm income and losses were to be calculated on a modified accrual basis with a cash basis reserve to allow positive farm income to be taxed on a cash basis. This cash basis reserve was to be based on the amount of inventory on hand, accounts receivable and prepaid expenses, less accounts payable, at the end of the year. A special valuation would be provided for race horses and show animals. For the majority of farmers who report positive farm income, these proposals would have retained the tax benefits of cash accounting, although not cash accounting itself.

- Farm losses calculated on the modified accrual basis would be fully deductible against off-farm income by farmers who met both the gross revenue and profit tests.

- Farm losses calculated on the modified accrual basis would be deductible against off-farm income to a maximum of $15,000 by farmers who met the profit test but did not meet the gross revenue test.

The modified accrual accounting proposal was designed to affect the taxes payable by farmers only in years in which they claim cash basis losses. For farmers on a cash basis under the existing system, a deductible loss may be generated by purchasing inventory and supplies, even if this inventory is on hand at the end of the year and has retained its value, leaving the taxpayer's economic position unchanged. Because under the White Paper proposal the cash basis

adjustment could be claimed only to reduce positive farm income to nil but not below, it would not have been possible to generate losses by purchasing inventory or farm supplies. Losses calculated on the modified accrual basis, however, which would have more closely approximated real economic losses, would be available to be deducted against off-farm income.

In recognition of the special circumstances of farmers, however, the White Paper proposal would not have required strict adherence to accrual accounting principles -- for example, the determination of the cost of crops grown or animals born on the farm. For the purposes of valuing inventory at the lower of cost or market value, farmers could have considered the cost of farm-produced inventory to be nil, effectively giving a cash basis write-off, rather than allocating direct and indirect costs of the farm operation to the cost of that inventory.

Consultations Concerning the Proposals

During consultations, it was apparent that there is broad agreement on the principle that taxpayers who are not truly in the business of farming should not have access to farm tax rules to shelter non-farm income. There was also agreement on the need to establish objective tests to determine the deductibility of farm losses, that is to determine who is a bona fide farmer. It was also the consensus that the proposed "three-years-of-seven" profit test was not unreasonable. Technical suggestions to improve this proposal were made.

However, concerns were expressed over the precise mechanism proposed to achieve these objectives. In particular, cash basis accounting is understood and well established in the farming community. Accordingly, the proposal requiring all farmers, including those in a profit position, to use the modified accrual accounting method was felt to be unwarranted. Some farmers were also concerned that modified accrual accounting was the first step towards the total elimination of cash accounting although there was no intention that this would be the case. Another concern was that the proposed gross revenue test for distinguishing between full-time and part-time farmers was not necessary.

New Approach for Consultation

As a result of the concerns raised during consultations, the government has decided to consult further with farm groups, in order to devise more appropriate measures to deal with these issues. In particular, the government understands the desirability of allowing farmers to continue to use the cash basis of accounting. The revised

proposals, therefore, will ensure that the option to use the cash basis of accounting for farm income will be maintained. Nevertheless, to prevent an increase in the use of farm tax shelters, measures must be introduced either to restrict cash basis losses in some manner, such as that proposed by the Commons committee, or to revise cash basis losses in such a way that they more accurately reflect the true operating losses.

Consultations will focus on the Commons committee's recommendation and on the alternative approach described below. As well, the government will consult on suggested improvements to the profit test and the gross revenue test. The approach to be selected will be effective no later than for fiscal periods commencing after December 31, 1988. However, if the consultations are completed quickly, legislation giving effect to these measures could be introduced earlier.

The Profit Test

The Commons committee recommended keeping the "reasonable expectation of profit" test and using "peer review groups" to determine whether a farmer does indeed have a "reasonable" expectation of profit.

Recent court decisions have demonstrated the unsatisfactory nature of the "reasonable expectation of profit" test. As well, there has been support expressed for new objective rules to provide certainty in this regard. The proposed rule that farm operations will be deemed to have a reasonable expectation of profit when they show positive income in three out of seven years has been viewed as not unreasonable in most cases. The government therefore intends to maintain this aspect of the objective profit test.

The profit test would be phased in in the manner provided in the White Paper, except that the transition period will commence at the same time as the new rules take effect.

The White Paper provided that farmers would still be allowed to deduct their farm loss in a year where they did not meet the profit test if they could demonstrate that they have a reasonable expectation of profit from farming on an ongoing basis. Although this would have provided the flexibility to prevent injustice in some cases, concern was expressed during consultations that this would continue the problems associated with the reasonable expectation of profit test. Accordingly, this part of the proposal will be amended to provide that farm losses may be deducted in a year in those circumstances where the taxpayer fails to meet the objective "three-of-seven-year" profit test, only if the taxpayer can demonstrate that he or she had a

reasonable expectation of profit in that year, that is, that he or she would have made a profit in that year in the absence of special circumstances such as drought, depressed prices, ill health, or other similar circumstances.

It is not proposed to accept the recommendation of the Commons committee for the establishment of peer review groups. Farm taxpayers are entitled to have their tax status determined according to the rule of law, as every other taxpayer does, and not by the judgment of other taxpayers. This recommendation would be difficult to reconcile with the confidentiality requirement of the tax law and carry with it the potential for inconsistent determinations in different regions of the country, as well as uncertainty, delay and expense for farm taxpayers. However, the government is prepared to consider creating a special group with farm expertise within Revenue Canada which may consult with Agriculture Canada and which would specialize in farm assessments.

The Gross Revenue Test

The gross revenue test was proposed to restrict the deductibility of the losses of part-time farmers to $15,000 by comparing gross farm sales to off-farm income. Concern was expressed during consultations that this test may be too lenient in some circumstances, and too harsh in others. It was suggested that, even adjusted for inventory and supplies, excessive losses may be generated by part-time farmers in order to shelter off-farm income, particularly during the period before the objective profit test is fully phased in. While the gross revenue test is arbitrary, the Commons committee recommendation to limit farm losses based on the level of off-farm income alone is not without problems for bona fide farmers -- particularly in times of low prices or poor climate. Accordingly, the gross revenue test will be the subject of further consultations with farm groups.

Start-up Farmers

The proposal described in the White Paper regarding start-up farmers is open for discussion purposes. That proposal provided that start-up farmers who could demonstrate that they have a reasonable expectation of profit would be exempt from the application of the profit and gross revenue tests for the first four years of the farm operation. As stated earlier, however, the reasonable expectation of profit test is uncertain and does not provide satisfactory criteria with which to evaluate the viability of a farm. Consequently, eligibility for start-up farmer status would require that the taxpayer demonstrate that he or she has a reasonable expectation of meeting the profit test within the first seven years of the operation. In other words, there must be a likelihood that the operation will show a profit, as it

would ultimately be required to do, in three of the first seven years. The method for demonstrating such an expectation will be the subject of further consultations.

The restriction on start-up farmer status to taxpayers who will ultimately be able to meet the profit test is intended to discourage the use of the generous provisions for start-up farmers as a new tax shelter vehicle. It is neither in the best interests of farmers nor the tax system to provide an incentive for speculators and other investors to get into farming strictly to benefit from the special tax provisions and to get out again after extracting the maximum tax advantage. Other restrictions on eligibility are also proposed to prevent the misuse of the start-up farmer exemption. For example, trusts would not be eligible for start-up farmer status, and eligibility would be limited to persons actively engaged in the day-to-day operation of the business or to family farm corporations where at least 2/3 of the shares are owned by persons who are so engaged. Similarly, the limited partnership at-risk rules would be extended to farm losses.

Calculation of Farm Income and Losses

The Commons Committee Approach

In substitution for the modified accrued accounting proposal in the White Paper, the Commons committee recommended that farmers be allowed to continue to use cash basis accounting but that the deduction for cash basis losses be restricted to a maximum of $10,000, and that this limit be reduced by $1 for each $2 of off-farm income in excess of $30,000. As a result, no cash basis farm losses would be deductible by farmers who had off-farm income in excess of $50,000. The committee recommended that no restriction apply to the deduction of farm losses calculated on an accrual basis but that a choice by a taxpayer to report on that basis in one year could not thereafter be changed.

The government does have some concerns with the introduction of a limit on the deductibility of cash basis losses based upon a formula approach as recommended by the Commons committee. The government is concerned that such an approach may unduly restrict the losses of bona fide farmers who account on a cash basis, and would force many farmers with real losses to choose full accrual accounting without any opportunity to use cash basis accounting, to their possible detriment.

Alternative Approach

As another alternative the government intends to seek the views of farm organizations concerning a proposal which would revise losses calculated on a cash basis to more accurately reflect real economic losses. Under this proposal, all farmers may continue to account on the cash basis, with special measures that would apply only where a cash basis loss is generated. In such cases, it is proposed that an inventory adjustment would be required, which would operate in a manner similar to the existing flexible livestock inventory provisions as found in the Income Tax Act.

The flexible livestock inventory provisions allow taxpayers who account on the cash basis to elect to increase their income from a farming business, or decrease their loss, by any amount not exceeding the fair market value of their livestock inventory on hand at the end of the year. A deduction of an equal amount is then taken in the next year. This election was introduced in recognition of the fact that cash basis losses may be generated by farmers simply by acquiring livestock, and that farmers should not be compelled to claim cash basis losses if it is not to their advantage to do so. This provision allows farmers to show sufficient income in the year to use other tax deductions and credits, and to moderate the wide fluctuations in farm profits and losses that can result from the use of cash accounting.

The proposal for an inventory adjustment would require that a loss calculated on the cash basis be reduced or eliminated to the extent that the farmer still has on hand certain inventory, the cost of which was deducted in the year or a previous year. The adjustment would apply to purchased supplies on hand such as feed, seed and fertilizer and to livestock inventory. Accordingly it would not apply to crops in the field or harvested crops. Losses could only be deducted to the extent that they exceed the cost or value of such inventory on hand at the end of the year. Any loss or portion of a loss disallowed in one year because of the inventory adjustment would be carried forward and deducted in calculating income for the next year.

Inventory and supplies that are subject to this rule would be valued for the purposes of this adjustment at the lower of cost or fair market value. An exception would be provided, however, for the valuation of horses. Because of the difficulty in determining the fair market value of these animals, horses would generally be valued at cost. An exception would be made, however, in a year in which a taxpayer could demonstrate that a horse had declined in value below cost, but in no case could this reduction be more than 10 per cent of the cost of the horse for each year that it was owned by the taxpayer. While the White Paper proposal recommended a 20 per cent

allowable reduction, this reduction was suggested in the context of a $15,000 loss limitation. Should a loss limitation be maintained as part of a gross revenue test the allowable reduction could be set at 20 per cent annually.

No special method of valuation would apply to show animals. Consultations on the White Paper proposal concerning show animals indicated that, although very few animals would fall into this show animal category, the provision might cause uncertainty concerning the proper method of valuation for animals which are shown for the purpose only of increasing their value for breeding purposes.

The following simple examples illustrate how the adjustment would operate.

1. Farmer A has a cash basis profit of $10,000 in a particular year. However, farmer A purchased $15,000 worth of livestock inventory. These animals are still on hand at the end of the year and are still worth $15,000.

   In the next year he sells them for $15,000 and has no inventory on hand at the end of the year.

   A. The Current System: Cash Accounting

      (i) Year One

Cash Profit Before Acquisitions	$10,000
Livestock Purchases	($15,000)
Cash Loss	($5,000)

      (ii) Year Two

Cash Profit	$15,000

   B. The Proposed System: Cash Accounting With Inventory Adjustment

      (i) Year One

Cash Profit Before Acquisitions	$10,000
Livestock Purchases	($15,000)
Cash Loss	($5,000)
Inventory Adjustment	$5,000
Farm Income	$0*

* Note that farmer A would still have the option of generating positive farm income through the flexible livestock inventory election in order to utilize his other deductions and personal credits.

(ii) Year Two

Cash Profit	$15,000
Previous Year's Inventory Adjustment	($5,000)
Farm Income	$10,000

2. Farmer B has an operating loss of $15,000 in a particular year. During the year farmer B purchases $15,000 worth of livestock inventory. Prior to the end of the year one-half of these animals are sold and the proceeds are reflected in the operating loss. The other half are still on hand and have retained their value, and are sold in the next year for $7,500.

A. The Current System: Cash Accounting

(i) Year One

Cash Loss Before Acquisitions	($15,000)
Livestock Purchases	($15,000)
Cash Loss	($30,000)

(ii) Year Two

Cash Profit	$7,500

B. The Proposed System: Cash Accounting With Inventory Adjustment

(i) Year One

Cash Loss Before Acquisitions	($15,000)
Livestock Purchases	($15,000)
Cash Loss	($30,000)
Inventory Adjustment	$7,500
Deductible Farm Loss	($22,500)

(ii) Year Two

Cash Profit	$7,500
Previous Year's Inventory Adjustment	($7,500)
Farm Income	$0

3. Farmer C has a cash basis profit of $25,000 before the deduction of $30,000 in interest expenses. However, farmer C purchases $10,000 worth of livestock inventory and $10,000 worth of supplies. Both the livestock and the supplies are still on hand at the end of the year and are still worth a total of $20,000.

In the next year, he sells the livestock for $10,000 and uses all of the supplies in his farm operation.

A. The Current System: Cash Accounting

(i) Year One

Cash Profit	$25,000
Interest Expense	($30,000)
Cash Loss Before Acquisitions	($5,000)
Purchases of Livestock and Supplies	($20,000)
Cash Loss	($25,000)

(ii) Year Two

Cash Profit	$10,000

B. The Proposed System: Cash Accounting With Inventory Adjustment

(i) Year One

Cash Profit	$25,000
Interest Expense	($30,000)
Cash Loss Before Acquisitions	($5,000)
Purchases of Livestock and Supplies	($20,000)
Cash Loss	($25,000)
Inventory Adjustment	$20,000
Deductible Farm Loss	($5,000)

(ii) Year Two

Cash Profit	$10,000
Previous Year's Inventory Adjustment	($20,000)
Deductible Farm Loss	($10,000)

4. Farmer D has a cash basis loss in each of three years of $5,000. However, farmer D purchased a racehorse for $25,000 in the first year and sold the horse for $15,000 in the third year.

A. The Current System: Cash Accounting

(i) Year One

Cash Loss Before Acquisitions	($5,000)
Racehorse purchase	($25,000)
Cash Loss	($30,000)

(ii) Year Two

Cash Loss	($5,000)

(iii) Year Three

Cash Profit	$10,000

B. The Proposed System: Cash Accounting With Inventory Adjustment

(i) Year One

Cash Loss Before Acquisitions	($5,000)
Racehorse Purchase	($25,000)
Cash Loss	($30,000)
Inventory Adjustment	$25,000
Deductible Farm Loss	($5,000)

(ii) Year Two

The racehorse is still on hand at the end of the year and farmer D can demonstrate that the horse has declined in value. The maximum allowable decline in value for horses would be 10 per cent. Accordingly, the value of the horse this year for the purpose of the inventory adjustment mechanism would be $22,500.

Cash Loss	($5,000)
Previous Year's Inventory Adjustment	($25,000)
Cash Loss	($30,000)
Inventory Adjustment	$22,500
Deductible Farm Loss	($7,500)

(iii) Year Three

Cash Profit	$10,000
Previous Year's Inventory Adjustment	($22,500)
Deductible Farm Loss	($12,500)

Had the horse not declined in value in the second year, the result in years two and three would have been as follows:

Year Two

Cash Loss	($5,000)
Previous Year's Inventory Adjustment	($25,000)
Cash Loss	($30,000)
Inventory Adjustment	$25,000
Deductible Farm Loss	($5,000)

Year Three

Cash Profit	$10,000
Previous Year's Inventory Adjustment	($25,000)
Deductible Farm Loss	($15,000)

Note that the total loss over the three years ($25,000) would have been $15,000 except that the horse was purchased for $25,000 and sold for $15,000.

As demonstrated by these examples, total farm income or loss remains the same over time, with fluctuations in farm income being less pronounced under the new proposal.

Clearly, however, a transitional provision is necessary with respect to the build-up of livestock inventory and supplies from years before the introduction of the proposed new rules which would be on hand and awaiting use or sale. In the absence of transitional relief, the requirement to adjust cash basis losses for this inventory might have the effect of requiring an adjustment of losses under the new rules for the cost of inventories that were acquired before the new system is introduced. This could have the effect of disallowing current operating losses for some farmers in the early years of the new system.

There are three possible ways of providing such transitional relief. These will also be the subject of consultations concerning the inventory adjustment proposal. The first two methods would require farmers to take an inventory of livestock and supplies at the beginning of the new system. Only inventory the cost of which was deducted after that date would be subject to an inventory adjustment provision.

The first method would require farmers to take note of which specific items of inventory are included in this opening inventory. Farmers would have to trace this inventory until it was ultimately sold or expended in the farm operation. This would be inconvenient and, in some cases, impossible.

The second method would require farmers to value their opening inventory. Only the value of year-end inventory and supplies in excess of that opening value would be subject to the inventory adjustment provision. The problem with this method is that this value would be carried forward indefinitely, even though the inventory might no longer be on hand. It would be possible to avoid the application of the new provision by ensuring that the total value of livestock and supplies on hand never dropped below that opening value. As well, because it would be possible for taxpayers to acquire significant inventories and supplies under the old system, report a large loss, and thereby defer indefinitely an equivalent amount of income, this method is susceptible to abuse. It is, therefore, not a practical approach.

The third, and recommended alternative, would not require farmers to take an opening inventory. In order to provide for the impact of the adjustment for inventory which is already on hand, the requirement to reduce cash basis losses would be phased-in over the first four years after the introduction of the new provision (for example, to reduce the amount of the inventory adjustment, from what it would otherwise be, by $15,000 in the first year and $12,000, $9,000 and $5,000 in the three subsequent years, respectively). The following examples illustrate how this transitional provision would operate.

1. Farmer A has a cash basis profit of $10,000, before the deduction of interest expense and livestock purchases, in the first year to which the inventory adjustment provision applies. Farmer A had interest expenses of $15,000 and purchased $30,000 worth of livestock of which $20,000 was on hand at the end of the year.

Cash Profit	$10,000
Interest Expense	($15,000)
Cash Loss Before Acquisitions	($5,000)
Livestock Purchases	($30,000)
Cash Loss	($35,000)
Inventory Adjustment ($20,000 - $15,000)	$5,000
Deductible Farm Loss	($30,000)

2. Farmer B has a cash profit of $20,000 before the deduction of interest expense and livestock purchases. He has interest expenses of $45,000. He purchases livestock worth $10,000 in the year, but also still has on hand livestock the cost of which was deducted in earlier years, for a total of $25,000 of this inventory on hand at the end of the year. It is the first year of the new system.

Cash Profit	$20,000
Interest Expense	($45,000)
Cash Loss Before Acquisitions	($25,000)
Livestock Purchases	($10,000)
Cash Loss	($35,000)
Inventory Adjustment ($25,000 - $15,000)	$10,000
Deductible Farm Loss	($25,000)

Conclusion

The Government is committed to ensuring that the tax system is fair and equitable to farmers. In order to maintain the existing benefits available to agriculture, however, the tax system must be changed to ensure that these benefits are not applied to other sources of income. Consultations will be held in an attempt to achieve a consensus on the appropriate mechanism to be introduced to accomplish this result in order that the goals of tax reform for farmers may be met in a manner that is understood and accepted by the farm community.