Sole Proprietorship

in Manitoba

This publication may contain outdated information.

Manitoba

Farm Sole Proprietorships in Manitoba

The surest way to reach a business goal is to plan on it. Successful Manitoba farmers are focused business people. They have clear, flexible, short and long term business plans – and they monitor their plans regularly.

Whether you're starting, growing or passing along your business, you need a solid business plan. And Manitoba Agriculture can help you build a plan for success.

Farm businesses are rapidly growing in size and complexity. The need for careful assessment of a farm operation and determination of which business structure best meets the needs of a farm is greater than ever. Understanding how a sole proprietorship is created, how it functions and the advantages and disadvantages of using this structure for your farm operation will provide assistance in making these decisions. Use this as a resource to help you be informed about the Sole Proprietorship business structure.

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Available in alternate formats upon request

Table of Contents

Definitions

Who is a farmer?

In tax and estate planning, the definition of farmer is important. Canada Revenue Agency defines a farmer as someone who is assuming all the risk in the farming operation. It does not matter who does the actual work. All the labour may be contracted out and the equipment rented, the individual assuming all the risk will still be considered a farmer.

Farming is not:

1. renting out land
2. share crop rental

These do not involve an individual assuming all the risk associated with the farm business.

Capital gains

When property is sold, there may be a difference between the fair market value and the original purchase price (cost base). A capital gain is the difference between the cost base of property (or V-Day value if owned prior to December 31, 1971) and its fair market value. When property is sold or the property owner dies, the *Income Tax Act* deems the vendor/deceased to sell at fair market value, and a capital gain (or recapture) may be generated. There are some exceptions for farm property.

Capital Gain = Fair Market Value – Cost Base

Currently in Canada, capital gains are 50 per cent taxable. Fifty per cent of the gain is included in your income and tax is paid at your marginal rate. Your marginal tax rate is the tax rate payable on your last dollar of taxable income. For tax planning, your marginal tax rate is what you'll likely pay on your next dollar earned. Canada operates on a system of graduated tax rates, where you will pay higher rates of tax as you earn more taxable income.

Capital gains exemption

As of 2015, every resident of Canada has a $1,000,000 exemption to use to offset capital gains that may occur when qualified farm property is sold or deemed sold.

Capital gains are presently 50 per cent taxable; every farmer therefore has an exemption capable of sheltering up to $500,000 of taxable capital gains.

Note that corporations do not have a capital gains exemption, only individuals do. However, if your farm is incorporated, the shareholders can use their personal capital gains exemptions on the sale of shares of a qualified farm corporation or, if a farming partnership, on the sale of a partnership interest in a qualified farm partnership.

Recapture

For depreciable assets such as buildings and equipment, recapture is the difference between the original cost and the undepreciated capital cost (UCC). UCC is the original cost of an asset, less the depreciation claimed in prior tax years. Recapture is fully taxable and does not qualify for the capital gains exemption.

Spouse / common-law partner

Common-law partners of three years or more and spouses have equal rights under Manitoba's family property legislation. Any time a spouse is referred to in these materials, the provisions apply equally to common-law partners of three years* or more or those who have registered their common-law relationship with Manitoba Vital Statistics.

Please note the *Income Tax Act* defines common-law partners as two persons that are in a conjugal relationship of at least twelve (12) months. Once two people are married or in a common-law relationship, for the purposes of the *Income Tax Act*, their combined incomes are used to determine eligibility for certain benefits and programs.

*There are many instances where property can be subject to equalization when a common-law partnership has existed for less than three years. For further information, please consult a lawyer knowledgeable in family law.

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What is a sole proprietorship?

A sole proprietorship is a business that is not separate or distinct from its owner. It exists when an individual carries on business in any trade or profession without establishing an alternative business arrangement, such as a corporation. The sole proprietor, who is also responsible for all of the debts and liabilities of the business, owns the business and all of its assets. The sole proprietorship is the simplest business arrangement available and therefore it is also the most common.

Farming is becoming an increasingly complex and sophisticated industry, but the sole proprietorship remains a very common farm business arrangement. The simplicity of the sole proprietorship allows a farmer to quickly and easily establish his or her farming operation and conduct business.

Creation of a sole proprietorship

A sole proprietorship exists as soon as an individual begins conducting business on his or her own behalf without entering into another form of business arrangement.

For example, Keith is a young man that wants to farm. His elderly neighbours agree to let him rent 320 acres for two years. Keith rents some farm equipment from his parents and seeds a crop. He purchases the seed and inputs from a local supplier in his own name. When harvest is finished he sells the crop to a grain buyer nearby. Keith has operated a farm business as a sole proprietor. The sole proprietorship continues to be a popular farm business structure because of its ease and simplicity. There are no legal requirements to establish a sole proprietorship, except with respect to business names.

Business names

A sole proprietor may choose to operate his or her business under his or her own name with no distinct business name. In Manitoba, farmers operating as sole proprietors do one or the other. In Manitoba there are legal requirements for the use of business names.

Family name as a business name

A sole proprietor may carry on business under his or her family name or surname without registering the business name with the Manitoba Companies Office. However, if a business is operated under a family name in conjunction with another word or designation and that name is not registered, *The Business Names Registration Act* requires that a sign, poster or advertisement be erected at the place of business indicating the full name of the person that operates the business.

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For example John McLeod operates a farm that has been in the family for more than a century. He operates as McLeod Farms. John has never registered McLeod Farms as a business name. *The Business Names Registration Act* requires John to erect a sign in the farmyard that states his full legal name and indicates that he is the proprietor of McLeod Farms.

John's son Lloyd purchases land near the farm operated by his father. He begins operating as LM Farms. The business name does not contain Lloyd's family name and therefore must be registered.

Registration of business names

The Business Names Registration Act requires anyone who carries on a business or intends to carry on a business under a name different than his or her family name to register the business name with the Manitoba Companies Office. If a sole proprietor is required to register a business name, the name will need to be reserved prior to registration. Reservation and registration of a business name prevents other businesses from operating under the same or a substantially similar name. To register a business name a declaration must be filed with the Companies Office setting out:

1. the name and place of residence of the sole proprietor
2. the nature of the business being carried on
3. the business name of the sole proprietorship
4. the address of the principal place of business of the sole proprietorship

A business name is to be registered within one month of the date on which the sole proprietor began carrying on business, or within the month immediately prior to the date on which a sole proprietor intends to begin carrying on business. Registration of a business name expires after three years and must be renewed before expiry.

Failure to comply with the requirements of *The Business Names Registration Act* can result in a fine of up to $500 per infraction.

Advantages of a sole proprietorship

Practical advantages

Absolute control over management

Every decision concerning the business is made by the sole proprietor. He or she is not responsible to any other person concerning the business. There is no obligation to seek the advice or recommendations of other people, although the sole proprietor may find it prudent to do so from time to time. Business decisions can be made very quickly, saving time and energy for other endeavours.

No unique legal requirements

A sole proprietorship comes into existence as soon as an individual begins carrying on business. If the sole proprietor does not operate the business under his or her own name, there may be requirements under *The Business Names Registration Act* to register a business name or erect a sign at the place of business.

Quick and easy to establish

Any person who begins conducting business by his or herself without another more formal business structure is a sole proprietor. Establishment of a sole proprietorship will only take as long and be as difficult as setting up the business itself.

Few ongoing formalities

A sole proprietorship lasts as long as the business owner continues in business. Unlike a partnership or corporation there are no regular filings with the Companies Office, unless a business name has been registered or is required to be registered.

Less expensive than a partnership or a corporation

A sole proprietor only files one income tax return and is not required to regularly file documents to continue the existence of the business entity. This saves on legal, accounting, and other professional fees, freeing up more money to be reinvested in the business.

No negative consequences of mixing business and personal assets

Unlike a corporation, where serious legal and tax consequences can arise if the business is treated like a personal bank account, a sole proprietor enjoys the ability to draw money from and add money to the business at any time and may freely use business assets for personal purposes without penalty.

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In a corporation or a partnership, the rights of other partners or shareholders must be considered when dealing with assets and money or legal action might be taken against a person who seems to disregard the interests of those stakeholders.

In a corporation, any money drawn for a personal purpose by a shareholder must be repaid within one year or Canada Revenue Agency will deem the negative balance to be income of that shareholder. If corporate assets are used for personal purposes Canada Revenue Agency may deem the individual using the assets to have received a taxable benefit and reassess the amount of income tax owed.

Taxation advantages

One income return and one income tax instalment

A farmer operating a business as a sole proprietor, and whose primary source of income is from the farm, is only required to file one income tax return. If taxable income is low, the farmer may be required to pay only one annual instalment towards income tax.

Income deferral

Unlike most other business owners, farmers are able to use the cash method to report income for tax purposes. Under the cash method, farmers are only required to report money actually received from the sale of farm products as income. The majority of businesses must report income using the accrual method in which income for the purposes of taxation is calculated including all sales made in the year, whether or not money has been received for the products sold.

The cash method allows farmers to deduct the cost of purchasing inventory such as seed, fertilizer, other crop inputs and livestock. This allows a farmer to reduce the amount of taxable income in any given year by making cash purchases. It should be noted that Canada Revenue Agency has stated that deductions may only be made if:

1. the expense relates to specifically identified goods that exist
2. the expense is reasonable taking into consideration the size of the farm operation
3. the goods must be delivered to the farmer or the supplier must be capable of delivering the goods
4. the goods must be used by the farming operation by the end of the following taxation year

Deferring income by purchasing inventory can help prevent drastic income fluctuations between good and bad years. This can be especially helpful to sole proprietors who are subject to the marginal income tax rates and are seeking to avoid having income that is subject to higher rates of taxation.

It is important to remember that income deferral does not provide any long-term planning opportunities. Purchasing inventory to offset income year after year can lead to a significant amount of tax being payable when a farmer leaves the business, sells the operation or dies. There may be no opportunities to plan to avoid tax. Consult your accountant and lawyer about the strategies that are best for your specific operation.

Farmers using the cash method are also able to use the optional inventory adjustment, which allows a farmer to add the fair market value of any unsold inventory on hand at the end of the year to his or her income. The value of the inventory added to income is deducted from income in the following year. Optional inventory adjustments are another way to help stabilize income from year to year. An optional inventory adjustment can be helpful to avoid losing non-refundable tax credits. Depending on your situation, using non-refundable tax credits may be more advantageous than low income or a loss that is carried forward. This is also a short-term strategy for avoiding income tax and you should consider long-term planning with your professional advisors.

It should be noted that the cash method may be used by farm corporations and partnerships, but the ability to defer or add income is most beneficial to sole proprietors subject to the marginal income tax rates.

Rollovers

In a farming operation there are generally two kinds of assets:

1. capital assets
2. inventory

Capital assets include land and depreciable assets such as buildings, machinery and equipment. Sale of a capital asset may result in either a capital gain or a capital loss. Sales of depreciable assets for more than the UCC will result in recapture up to the original cost of the asset. One hundred per cent of recapture is included as taxable income. Fifty per cent of capital gains that have accrued since December 31, 1971, or the date the capital assets were acquired, whichever is later (less any capital expenses, such as tile drainage, additions to buildings, etc.), are included in an individual’s taxable income upon disposition of the assets on which the gain has accrued.

Inventory generally includes all assets bought and sold in the course of operating a business. When inventory is sold, the entire amount realized on the sale is taxable income.

The *Income Tax Act* contains provisions that allow capital assets used principally in the business of farming to be transferred from an individual farmer to his or her children in a manner that delays or defers realizing a taxable capital gain. Transfers of assets on this kind of a tax deferred basis are commonly referred to as rollovers.

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To determine whether or not an asset is used principally in the business of farming, Canada Revenue Agency will examine:

1. whether or not the asset is used more than 50 per cent of the time in the farming business
2. whether or not the asset has been used more than 50 per cent of the time in the farming business for more than 50 per cent of the time the farmer has owned it;

Intergenerational rollover

A farmer can transfer personally owned capital assets used principally in the business of farming to his or her children during his or her lifetime (pursuant to section 73(3) of the *Income Tax Act*) or on his or her death (pursuant to section 70(9) of the *Income Tax Act*). The normal definition of a child in section 252(1) of the *Income Tax Act* includes:

- natural children of the taxpayer
- stepchildren of the taxpayer
- any person who was a dependant of the taxpayer and in the custody of the taxpayer immediately before attaining the age of 18
- a spouse or common-law partner of a taxpayer's child

Section 70(10) of the *Income Tax Act* expands this definition for the purposes of farm rollovers to include grandchildren and great-grandchildren of the taxpayer.

Rollover during lifetime

Capital assets used principally in the business of farming may be transferred to a child, as defined above, by sale or gift from a farmer pursuant to section 73(3) of *The Income Tax Act*. If the property is gifted, the child acquires the property with a UCC or cost base equal to that of the parent farmer. Canada Revenue Agency deems the parent to have sold for an amount equal to his or her UCC or cost base. The result is that the parent farmer does not suffer any tax consequences and the burden of recapture or capital gain rests with the child on any future sale of the assets by the child.

There may be reasons a parent would want to sell to a child rather than gift to that child. Usually this is to accomplish other tax planning strategies. For example, Clark owns 640 acres of land, having a cost base of $1,000 per acre. The fair market value of the land is $2,500 per acre. Clark also owns equipment worth $1 million that originally cost $800,000. The UCC of the equipment is $200,000.

Clark wants to retire, and to do so he must be able to draw at least a portion of his equity out of the farm. Clark decides that he will sell the farm to his son Rusty at two-thirds of fair market value so that he can draw out his equity while still providing Rusty with a more advantageous position from which he can begin farming on his own. Clark discusses his plan with his lawyer who advises him to give Rusty a break on the farm equipment not qualified for the capital gains exemption and subject to recapture which is fully taxable. The lawyer advises that the farmland qualifying for Clark's capital gains exemption should be sold.

Clark can gift the land to Rusty or sell it to him at any price up to fair market value. If Clark sells for fair market value his capital gain is $1,500 per acre or $960,000, of which 50 per cent ($480,000) is taxable. Clark can use his capital gains exemption and pay no tax on the capital gain. Rusty can either obtain a mortgage to pay the entire balance to Clark, or provide Clark with a promissory note and collateral mortgage directly and pay Clark over time.

If Clark sells the equipment to Rusty at any amount between $200,000 and $800,000, he will have recapture. All recapture is considered taxable income and, in this situation, would likely be taxed at the highest marginal rate of 46.4 per cent. If Clark gifts the equipment to Rusty or sells it to Rusty for UCC or less, Clark will have no recapture.

By organizing his sale to gift the equipment and sell the land, Clark can provide Rusty with an advantageous deal for the farm and still avoid paying tax on the transactions.

Please note that there may be other tax consequences arising from the example transactions set out above. If you are considering similar transactions, please consult an accountant and lawyer experienced in taxation issues.

It is important to note that, if a farmer gifts or sells a capital asset to a child during his or her lifetime for less than fair market value and the child sells the capital asset within three years, section 69(11) of the *Income Tax Act* provides that the farmer will be deemed to have received fair market value on the original transfer to his or her child. If a farmer is transferring capital assets to a child for less than fair market value it may be advisable to have the child sign an indemnity in which the child promises to relieve the farmer of any liability if the child sells in less than three years. This protects the farmer from unforeseen and uncontrollable tax liability.

To qualify for the farm rollover during the lifetime of the transferor, the property being transferred must simply meet the test that it was used principally in the business of farming.

A rollover of shares of a farm corporation, either during the lifetime of the transferor or on the death of the transferor, can only occur if 90 per cent of the farm corporation's assets are used principally in the business of farming, which is a much more difficult test to meet. A sale of shares is also harder to arrange and more expensive than a sale of assets.

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Rollover on death

Assets may be rolled over on death to a deceased farmer's children. The transfer on death is automatically deemed to be at the farmer's UCC or cost base. The executor or administrator of the estate may elect for the transfer to take place anywhere between cost base or UCC, as the case may be, and fair market value on the farmer's year of death tax return. This is usually done to use any remaining capital gains exemption or unused losses.

It is important to ensure that any remaining capital gains exemption is used in the year of death return. This provides a higher cost base of land for the succeeding generation, reducing the future potential tax burden. There is no Alternative Minimum Tax in the year of death. The only potential issue to be aware of is clawback of Old Age Security and other government benefits. Clawback occurs as a taxpayer's income rises to a specified threshold and the government demands that any benefits received be repaid. It is important to speak with a qualified accountant and lawyer if you are involved with the estate of a deceased farmer.

Rollover to a corporation

Under subsection 85(1) of the *Income Tax Act*, a farmer may start a corporation and elect to sell eligible capital property to the corporation for a price anywhere between the farmer's cost base and fair market value. The farmer may use his or her capital gains exemption if the amount elected is above his or her cost base. A farmer can also transfer depreciable property, such as machinery and equipment, to the corporation at UCC, taking back preference shares to avoid paying immediate tax. Electing an amount that is higher than UCC is not advisable, because the capital gains exemption cannot be used to offset recapture.

After using the capital gains exemption, a farmer who transferred his or her assets to the corporation can receive payment of the purchase price from the corporation, less the value of any shares issued and debts assumed by the corporation, without further income tax consequences.

More favourable capital gains exemption and rollover rules

If an individual owns farmland personally and that farmland was acquired prior to June 17, 1987 and farmed for at least five years in total by the individual or his or her spouse, parent, grandparent or great-grandparent, the individual, his or her spouse, children, and grandchildren all qualify for the capital gains exemption and rollover with respect to that farmland. It is relatively easy for sole proprietors to qualify for the capital gains exemption and rollover under the pre-1987 rules, especially in the case of multigenerational farms.

An individual will qualify for the capital gains exemption and rollover with respect to farmland acquired after June 17, 1987 if the individual farmed the land for more than half of the time he or she has owned it and has derived more income from farming than from any other source for 24 consecutive months.

A corporation does not have a capital gains exemption and cannot transfer property by way of rollover. If a corporation sells land it will pay tax on any capital gain realized. The shares of a farm corporation may be eligible for the capital gains exemption and rollover, but the test is much more stringent:

1. A corporation must use 90 per cent of its assets in active business.
2. The shares must be owned for at least two years prior to the disposition.
3. The corporation must have used its farm assets in the business of farming more than 50 per cent of the time for at least two years prior to the disposition.

Although sole proprietorships do provide advantages with respect to the capital gains exemption and rollover, it is important to consider what business structure best suits the long-term needs of your farming operation. With proper planning, the challenges corporations and partnerships pose with respect to the capital gains exemption can be overcome. It is important to remember that a partnership or corporation can provide the opportunity to take advantage of the capital gains exemptions of a spouse, common-law partner and adult children. Use of a family trust can also provide access to multiple capital gains exemptions, especially when a family farm corporation is involved. For further information on farm partnerships, farm corporations and family trusts please refer to our guides *Farm Corporations in Manitoba, Farm Partnerships in Manitoba* and *Family Trusts in Manitoba*.

Principal residence exemption

Every individual may elect one principal residence in each taxation year. The principal residence exemption provides a formula for reducing or even eliminating taxable capital gains that may arise on the disposition of the property. The formula is:

$$\frac{\text{Number of years the property is elected as the principal residence + 1}}{\text{Total number years of ownership}}$$

The resulting figure is the proportion of any taxable capital gain on a principal residence that is exempt from taxation.

On a farm, a principal residence is considered to be the house and one half hectare (1.24 acres). A farmer will have to show that more than 1.24 acres are reasonably necessary to the use and enjoyment of the residence if he or she intends to claim that more than 1.24 acres form part of the principal residence. For example, if the minimum lot size is two acres for a subdivision in your municipality, you have a strong argument that the entire two acres are reasonably necessary to the use and enjoyment of your residence.

On the sale of farmland where a principal residence is situated, part of the purchase price can be allocated to the principal residence and the remaining part to the farmland. This can reduce the amount of capital gains exemption that the farmer must use to avoid tax on the sale.

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For example, David owns 480 acres. His cost base of the land is $500. David built a large house on his home quarter with two acres of landscaped gardens for his wife Lucy. Construction and landscaping of the home cost $200,000. Lucy is having mobility problems as they get older and David wants to sell the farm and move to town. David wants to sell the farm for $2,500 per acre and an additional $400,000 for the house and yard.

David only has his own capital gains exemption as Lucy used hers when she sold land she inherited from her father. David faces potential capital gains of $1.16 million, which exceeds his capital gains exemption. However, David allocates the purchase price to his principal residence, which has a fair market value of $400,000, and which he and Lucy lived in the entire time they owned it. David can use his principal residence exemption for the house and yard, pay no tax on that $400,000 and use his capital gains exemption for the remaining 478 acres. His farming capital gains are brought below $1 million and he can avoid paying tax on capital gains altogether.

It is important to note that corporations do not have principal residence exemptions. Speak with your lawyer and accountant about creating a principal residence agreement if you are planning to live on land owned by a corporation. You may be able to maintain your personal principal residence exemption and avoid being deemed to receive a taxable benefit from the farm corporation.

Disadvantages of a sole proprietorship

Practical disadvantages

Unlimited liability

A sole proprietor is personally responsible for all of the debts of his or her business. A sole proprietor's personal assets can be seized by creditors because the sole proprietor and the business are the same entity. Business assets can also be seized if the sole proprietor has creditors unrelated to the business.

For example, Cliff farms a section of land and does work as a long distance truck driver. He operates both businesses as a sole proprietor. Cliff has always kept his trucking business separate from his farm and has separate bank accounts and accounting records. Cliff has a third bank account that contains $25,000 he inherited from his uncle. Cliff suffers a crop failure and is unable to pay his chemical and fertilizer bills. The supplier sues Cliff and successfully seizes Cliff's trucking assets and bank account with inheritance funds by obtaining garnishing orders. As a sole proprietor, Cliff is not legally separate or distinct from either of his businesses and as a result all of his assets can be seized by creditors.

As another example, Myrtle operates a farm as a sole proprietor. Myrtle enjoys travelling during the winter months and spends a lot of time in the United States. Myrtle is in a car accident in the United States and is found to be at fault. She is sued for damages and the American court awards damages of $2 million against her. Myrtle only carries $1 million of liability insurance through Manitoba Public Insurance and she soon finds that her farmland and equipment are being seized to satisfy the judgment.

A sole proprietor is also personally liable for any harm caused to a third party in the course of operating his or her business. For example, if Cliff or his employee sprayed his fields on a windy day and damaged or destroyed his neighbours' crops, his neighbours could sue him and seize his assets that are unrelated to the farm. If you are farming as a sole proprietor, you should consult your insurance agent about liability insurance to protect yourself and your operation. Incorporating your farm business is another possibility to limit liability.

It should be noted that general partners in a partnership have the same unlimited personal liability for the partnership business as a sole proprietor has for his or her business. Because each general partner is liable for all debts of the partnership, a partner who does not contribute an appropriate share toward debt repayment can be sued by the other partners, who can seize the partner's assets to enforce the contribution.

Limited access to resources

A sole proprietor is limited to his or her own income history and pool of assets when seeking loans. The level of income and value of collateral assets are important factors for a financial institution to consider when determining what amount it is comfortable lending. Partnerships and corporations have an advantage when seeking to borrow money, because they generally have a larger number of people involved to guarantee the loan. Sole proprietorships may have less borrowing power, especially if the farm operation is small. Less borrowing power can mean a farming operation does not expand or keep up with changes in technology.

Limited opportunities for the next generation

Sole proprietors do not share control over the operation of a business. A sole proprietor may consider the advice of others, such as a spouse, parents or children, but responsibility for the business rests with the sole proprietor. If a sole proprietor shares control and management of the business, he or she risks being deemed to be in partnership by Canada Revenue Agency and it may cause unintended tax consequences.

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In a sole proprietorship, it is more difficult to gradually give the next generation a more active role in operating the farm. As a sole proprietor, a farmer can only involve his or her children in the operation by hiring them as employees. Although the farmer maintains control, the farmer may be depriving his or her children of valuable experience in managing and being responsible for a farm.

For example, Frank has operated a farm for 50 years. His son Andy has been involved in the farm's operations since he was old enough to operate a tractor. Frank never involved Andy in managing the business and financial affairs of the farm. Frank continued to make all of the decisions while Andy increasingly performed all of the work. Frank died and Andy suddenly became the sole proprietor of the farm. Andy made some poor business choices in the first few years after Frank died and suffered significant stress and financial pressure as a result. If Frank had been more willing to involve Andy in management of the farm and give him some valuable advice and experience, Andy may have been able to avoid some of the problems he faced after Frank's death.

Business limited to life of sole proprietor

Unlike a corporation or a partnership, there is no way to continue a sole proprietorship beyond the life of the sole proprietor. The sole proprietor can transfer property to another individual on his or her death, but the business operated by the individual receiving the property would be a new business.

Business name similarities

If a sole proprietor is operating a business under his or her family name and does not register the name, it is possible for someone else to use the same business name. For example, John McLeod may be surprised to learn that there are three other farm businesses in Manitoba operating under the name McLeod Farms.

Taxation disadvantages

Limited opportunities to income split

A sole proprietor must declare all of the income earned from the farm business in the year in which it occurs. The sole proprietor farmer and the farm business itself are not separate legally or for tax purposes. This limits the ability of the farmer to split income with his or her family members. Of course the farmer can employ his or her spouse or children and pay them a reasonable amount for the work performed, but few other options exist. Remember, Canada Revenue Agency may determine the amount paid is not reasonable unless it's within range of going rates for the same or similar work.

It is much easier to transfer income to a spouse, common-law partner or children if a farm is operated through a partnership or corporation.

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Limited opportunities to control income

In a corporation or a partnership, there are ways for a farmer to control his or her level of income in a year. In a sole proprietorship there is no control. All income belongs to the sole proprietor. If a farmer has very high income in one year and none in the following year, the farmer will pay at the high marginal rates in the year he or she has high income. He or she may also lose non-refundable tax credits in the year that there is a low income or a loss. As discussed above, this effect can be avoided by purchasing inventory in years with high income and using the optional inventory adjustment in years with low income.

The inability to control income can have serious and unintended financial consequences for the spouse or common-law partner of a farmer.

Income can affect benefits of a spouse or common-law partner

Whenever two individuals get married or begin living together in a common-law relationship, the change of marital status must be reported to Canada Revenue Agency. The *Income Tax Act* defines a common-law relationship as two people being together in a conjugal relationship for at least twelve (12) months. If a farmer is married or in a common-law relationship, his or her income can significantly affect spouse or common-law partner eligibility for benefits.

If a farmer has high income from the farm business or from capital gains, it can disqualify a spouse or common-law partner from benefits such as GST credit payments, Canada Child Tax Benefit and the Old Age Security (OAS) Guaranteed Income Supplement. If a change of marital status is not reported and benefits are paid to a recipient not entitled to them, Canada Revenue Agency may seek repayment of those benefits.

For example, John and Nancy have been living in a common-law relationship for ten years. John and Nancy have never reported their marital status to Canada Revenue Agency. Nancy has always had low income and receives the OAS Guaranteed Income Supplement and GST credit payments. John farms as a sole proprietor. In the first two years of the relationship John had taxable capital gains from selling a piece of land. In the following three years John had good crops with strong prices and earned a high level of income. Droughts in the sixth and seventh years resulted in John having a very low income. John's income is high again for the last three years of the relationship. John dies without a will and Nancy applies to be the administrator of his estate. Nancy also applies for the Canada Pension Plan death benefit. Canada Revenue Agency, now aware that Nancy was in a common-law relationship with John, reassesses Nancy and determines she was not eligible for the OAS Guaranteed Income Supplement and the GST credit payment for the eight years John had a high income. Canada Revenue Agency now demands repayment of all of the benefits she received during the eight years she was ineligible.

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It is important to notify Canada Revenue Agency as soon as your marital status changes to prevent a reassessment and a demand for repayment of benefits. It is also important to speak with your accountant and lawyer about the effect your farming income may have on your spouse or common-law partner.

Less income available to reinvest due to rates of taxation

Individuals pay tax on income at rates that increase with the level of income earned. Federal tax rates on individual income for 2015 are calculated by adding together:

- 15 per cent **on the first** $44,701 of taxable income
- 22 per cent **on the next** $44,700 of taxable income (on the portion of taxable income over $44,701 up to $89,401)
- 26 per cent **on the next** $49,185 of taxable income (on the portion of taxable income over $89,401 up to $138,586)
- 29 per cent of taxable income **over** $138,586

The provinces have also established rates of taxation that increase as the amount of income earned increases. Manitoba tax rates on individual income for 2015 are calculated by adding together:

- 10.8 per cent **on the first** $33,000 of taxable income
- 12.75 per cent **on the next** $36,000 of taxable income (on the portion of taxable income over $33,000 up to $67,000)
- 17.4 per cent of taxable income **over** $67,000

When the rates are combined, Manitobans pay tax ranging from 25.8 per cent on the first $33,000 of taxable income up to 46.4 per cent on taxable income over $138,586.

By comparison, the federal and provincial governments have implemented preferential tax rates for Canadian controlled private corporations (corporations controlled by Canadian residents). The federal government has set a base tax rate of 38 per cent for all income earned through a corporation. This rate is reduced by 10 per cent to allow for provincial taxation of a corporation’s income. Taxation of the first $500,000 of active business income is reduced by a further 17 per cent and is therefore subject to a federal income tax rate of only 11 per cent.

Manitoba also has two different tax rates for corporations. In Manitoba, the first $425,000 of active business income is not subject to any provincial income tax. Active business income above $425,000 and all other sources of income are subject to a provincial tax rate of 12 per cent.

In 2015, the Manitoba government proposed increasing the active business income tax exemption for corporations to $450,000. If implemented, this proposal will take effect on January 1, 2016.

Because corporations in Manitoba pay tax at only 11 per cent on the first $425,000.00 of active business income, a corporation will have more money available for reinvestment in the business after tax. For example, Henry farms as a sole proprietor. In 2015, he earns $100,000 of taxable income. Assuming he has no deductions, Henry will pay approximately $33,191 in income tax, leaving him with $66,809 to service farm debts, provide for his family and reinvest in the business. If Henry must make $40,000 in payments to service his farm debt, there is little income left for his family or further investment in the business.

If Henry had been farming through a corporation and the corporation had earned $100,000 of active business income, the corporation would have paid $11,000 of income tax. After paying $40,000 to service the farm debts, Henry's farm corporation continues to hold $49,000 a portion of which can be kept to reinvest in the corporation and the balance can be paid to Henry and his family by way of salary or dividend. Henry and his family will have to pay personal tax on any income received from the corporation, but this will likely be calculated at the lowest marginal rates.

If a sole proprietor is trying to increase the land base of his or her farm and is bidding on land against incorporated farmers, the sole proprietor is at a distinct disadvantage. The higher amount of taxes the sole proprietor will pay on income before being able to service debts reduces the size of payments the sole proprietor can make and therefore the eligibility for financing. This also reduces the ability of the sole proprietor to submit a competitive and successful bid.

Alternative minimum tax

An individual who benefits from tax deductions or credits, such as the capital gains exemption, becomes subject to the greater of basic tax or the minimum tax. The alternative minimum tax (AMT) is essentially a prepayment of taxes. AMT may be applied against taxes owing in the seven years immediately following the year in which it was paid.

If taxes owing do not exceed the amount of AMT that is paid by the end of seven years, the balance is lost. It is important to consider when it may be advisable to realize a capital gain and use your capital gains exemption. In the year of death there is no AMT and it may be the most beneficial to wait until a farmer's death. If a capital gain is realized and the capital gains exemption is used during a farmer's lifetime, health and probable life span should be considered. If the farmer dies four years after paying AMT and has not recovered the complete balance, it is lost.

It is important to speak with your accountant and lawyer about proper planning whenever you are considering transactions that may realize capital gains and AMT. For more information about AMT please see our guide *Taxation - Alternative Minimum Tax* for further information.

 This publication may contain outdated information.

Capital gains can cause old age security clawback

If an individual's net income exceeds a certain annual threshold, a portion of old age security (OAS) benefits must be repaid. In 2015, the threshold net income is $72,809. The amount of the clawback is equal to the OAS received or 15 per cent of the amount by which the individual's income exceeds the threshold, whichever is less.

Half of all capital gains are taxable and farmers have a lifetime capital gains exemption of $1 million ($500,000 taxable capital gains). If the entire capital gains exemption is used in one transaction, the individual farmer will have over $500,000 of income and OAS will be clawed back completely. This can be a significant and unexpected payment that the farmer has to make. Child tax benefits are also subject to clawback. It is important to consult with your accountant and lawyer about whether or not you might be subject to clawback.

Limited ability to use multiple gains exemptions

A sole proprietor is limited to his or her own capital gains exemption on the disposition of farm assets. This is perhaps the most significant disadvantage of a sole proprietorship from an income tax perspective. Use of more than one capital gains exemption will require more planning on the part of the farmer and his or her advisors than if the farmer made use of a corporation or family trust, or both. For more information on the taxation advantages of corporations and family trusts please refer to our guides *Farm Corporations in Manitoba* and *Family Trusts in Manitoba*.

A sole proprietor is unable to defer tax on assets such as inventory in the same way that partners can through sale of partnership interests and use of the capital gains exemption. For more information on the taxation advantages of partnerships, please refer to our guide *Farm Partnerships in Manitoba*.

This publication may contain outdated information.

Family law considerations

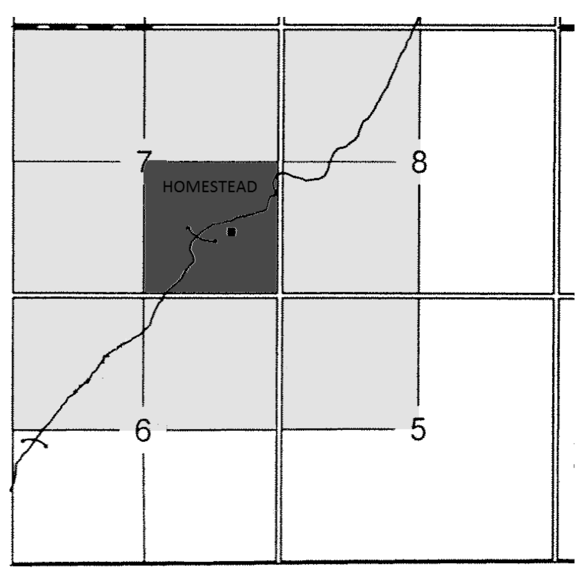
Family property

Any property purchased during a marriage or common-law relationship is likely to be subject to an accounting and equalization under *The Family Property Act*. Any increase in the value of property purchased before the marriage or common-law relationship will also likely be subject to an equalization and accounting. Land prices in Manitoba have risen dramatically since 2010 and land may have to be sold to obtain sufficient funds to pay an equalization payment in a relationship breakdown.

Homestead rights

As discussed above, a sole proprietor owns all of the assets of the business personally. When a sole proprietor owns farmland and has a spouse or common-law partner, the proprietor may be subject to the rights of the spouse or common-law partner under *The Homesteads Act*.

When an individual resides outside of a city, town or village a homestead includes the quarter section (or smaller parcel of land) on which the family home is located and any adjacent land to a maximum of 320 acres. The diagram below shows there is a home located on the southwest quarter of section seven. If a sole proprietor owns that quarter section and lives there with a spouse or common-law partner, the land is subject to the homestead rights of the spouse or common-law partner. Assuming the southwest quarter of section seven (in dark grey) is homestead property, if the sole proprietor owns any of the eight quarter sections immediately adjacent to that quarter section, they may also be considered homestead property. A spouse or common-law partner does not obtain homestead rights in more than 320 acres.



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Homestead rights require the owner to have consent from a spouse or common law partner before:

- granting someone else an interest in the land
- transferring the land
- selling the land
- making an agreement to sell the land
- giving someone else an option to purchase the land
- giving someone else a right of first refusal to purchase the land
- leasing the land for more than three years
- leaving the land to a beneficiary in a will
- mortgaging the land
- doing almost anything else that could affect the owner's title to that land

If the owner dies, his or her spouse or common-law partner acquires the right to own, use and enjoy the homestead property for the duration of their natural life. This includes the right to receive income from the land. If the owner intended his or her children to farm the land, they may not be able to do so without paying the surviving spouse or common-law partner rent.

Summary

Sole proprietorships have advantages and disadvantages as a business structure for farmers. In most cases the disadvantages outweigh the advantages. Unlimited liability and the inability to succession plan using multiple capital gains exemptions are the most significant reasons to use an alternative business structure. Farmers should always consult with accountants and lawyers who specialize in farm business and taxation issues when making these crucial decisions.

Contact us

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