Understanding the Federal Tax Deferral – Advisors Guide

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Following on the article, "Understanding the Federal Tax Deferral", the following discussion offers more detail for farmers and their professional advisors when calculating the deferral available and in formulating the best strategy when dealing with a drought induced herd reduction.

Dollar Value of Breeding Animal Sales:

In arriving at the dollar value of breeding animal sales available for deferral, you must deduct any purchases of breeding animals which are made in the current taxation year.

In the Income Tax Act, section 80.3 (1) it defines "breeding animals" as deer, elk, and other similar grazing ungulates, bovine cattle, bison, goats, sheep, and horses that are over 12 months of age, and are kept for breeding.

This requires that the animals must have been breeding animals at the time of acquisition. Breeding animals include animals that are over 12 months of age and are kept for breeding purposes.

For the purpose of explanation, we will use bovine cattle.

Consider the following cattle example:

At December 31, 0000 a farmer has 40 cows. In January 0001, he acquires 80 heifers which are 10 months old. The cattle are bred in the summer of 0001, but due to feed and pasture restriction; the bred heifers are sold in the fall of 0001 along with the 30 cows.

Based on the definitions, the farmer's breeding herd at December 31, 0001 would be 25% of his breeding herd at December 31, 0000. Therefore, the farmer would be able to defer 90% of the proceeds of sale for certain animals. The amount eligible for deferral is the taxpayer's income for the year from the business in respect of the sale of breeding animals in the year, minus amounts deducted in computing the taxpayer's income from the business for the sale in respect of the acquisition of breeding animals.

Since the heifers purchased in January 2001 to 0001 were under 12 months of age at the time of acquisition, they would not be considered breeding animals, and the purchase value would not be deducted from the deferred amount. However, the heifers would be considered to be breeding animals at the time of sale.

Conclusion: The 90% of the gross proceeds for the 80 bred heifers and 30 cows sold during the year would be able to be deferred under the livestock deferral rules. The amount paid for the heifers in January would still be a deduction from income for the current taxation year!

What age of cattle will qualify for the deferral?

The impact of age for the definition of breeding animals is also crucial to determining which sales are eligible for deferral.

Consider the following example:

At December 31, 0000, a farmer has 40 cows and 300 heifers (which are less than 12 months of age). At December 31, 0001, the farmer has 10 cows. The heifers he owned at December 31, 0000 were sold in August 0001. At that time, they had been bred and were over 12 months of age.

Based on the definitions, the farmer's breeding herd at December 31, 0001 would be 25% of his breeding herd at December 31, 0000. Therefore, the farmer would be able to defer 90% of the proceeds of sale for certain animals. The amount eligible for deferral is the taxpayer's income for the year from the business in respect of the sale of breeding animals in the year. Since the heifers sold in August were bred and that they were over 12 months of age at the time of sale, they would fit the definition of breeding animals.

Conclusion: The 90% of the proceeds for the 300 bred heifers and 30 cows sold during the year would be eligible for deferral under the livestock deferral rules.

Definition of "Breeding Herd" is Important

If you sell more bred heifers than cows, this may pose a problem through the definition of "breeding herd". The determination of the size of the breeding herd limit eligible sales. In particular, if first calf bred heifers exceed 50% of the cowherd; the inventory is limited to that 50% restriction.

Consider the following example:

On December 30, 0000, a farmer has 40 cows and 100 heifers bred to calve for the first time in 0001. During 0001, the farmer sells 80 of the bred heifers, keeping 20 which are bred.

Working through the definition of a breeding herd, the breeding herd numbers 60 animals at December 31, 0000 and 60 at December 31, 0001. Given that the first calf bred heifers exceeded 50% of the cowherd; the inventory is limited to the 50% restriction. In our example, 50% of 40 cows are only 20-bred heifers.

Conclusion: The other 60-bred heifers are not eligible to be included in determining their opening and closing inventory numbers. Since no reduction in breeding herd has occurred, no income from the sale of the bred heifers can be deferred.

Corporations and Deferrals

Can I form a Corporation to access the low corporate rate upon the sale of the cattle and gain an extra year of deferral?

An individual may be able to set up his affairs in a manner that allows a strategy to take advantage of both the low corporate tax rate on the first $250,000 of taxable income to which a corporation has access to and also to take advantage of an extended time period under drought deferral rules.

In order to accomplish this, an individual could roll their cattle into a Company at a date during the calendar year. The company then elects to have a year-end shortly after the cattle are rolled into the company, assuming a newly incorporated company. For example, if the cattle are rolled into the company on June 1, 0001, the company may elect to have a June 30th year-end. This short fiscal period is required to ensure the corporation has opening inventory in 0001.

The company would file a financial statement and tax return for that period, but assuming the cattle had not yet been sold, there should not be any taxable income.

The company would then have a June 30th year end from that point forward. Since the farm is located in a Prescribed Drought Region for 0001, the Corporation would have the ability to take advantage of the drought deferral if the cattle are sold anytime during the year up to June 30, 0002.

Conclusion: The deferral, is one fiscal year after the year of sale therefore, the corporation would have the option to buy back cattle until June 30, 0003, thus gaining an extra year to deal with the deferral sale amount. The corporation would also be able to take advantage of a full $250,000 small business deduction, because it has a full fiscal year and is not subjected to a pro-rated small business deduction.

Is Re-Purchase of Breeding Stock Required?

When the deferral collapses, there is no requirement to purchase "breeding animals" or any class of livestock. The deferral simply collapses and is treated as an active farm income in the current fiscal period.

Treatment of the Deferral Under Agri-Stability

Regarding the question of how the drought deferral is treated for the purposes of Agri-Stability, in the year of sale, the entire sale proceeds; including the deferral amount will be recorded as eligible income for Agri-Stability. As Agri-Stability uses a modified accrual methodology, the reduction in year-end inventory should offset this income when calculating the current year's Production Margin. It is Agriculture Financial Services Corporation's (AFSC) present policy to not apply the structural adjustment calculations in the year of a drought-induced sale.

If in a following year, the deferral is collapsed, and the income is shown on the farm income tax statement, AFSC will exclude this deferred income as it was already reported for CAISP purposes in the year of sale. If no subsequent cattle are purchased, AFSC will then apply their structural adjustment calculations and will reduce the prior reference year's Production Margins.

If sufficient cattle numbers are repurchased, no structural adjustment will be applied to the prior years production margins. The current year's expense for the cattle purchased will be offset by the increase in inventory year-end calculations resulting in no impact on the current year's Production Margin.

Conclusion: Under Agri-Stability the deferred amount is treated as eligible income in the year of sale and NOT when reported for Income Tax purposes.

If you have questions or require further assistance on this topic,

please call the Ag Info-Centre at 310-FARM (3276)