

**2007  
Atlantic Tax Conference**

**Tax Developments in the Fishing and Farming Industries**

**T. Chris Thomson, BA, LL.B., TEP**

As is often the case, some of the most significant developments and those with the greatest impact on tax planning do not come from revisions to the *Income Tax Act* (Canada). This has certainly been the case in recent years in terms of planning done relative to the fishing and farming industries in Canada and particularly here on the Atlantic Coast. While John F. Oakey's paper presented to this conference under the same title will deal with the various legislative changes incorporated in the *Income Tax Act* (Canada) which have effected these industries, this paper will instead focus on policy, program and legislative changes outside of the *Income Tax Act* (Canada) and the tax planning issues and opportunities which have developed therefrom.

While it would be fair to say that most of the farming industry has been focused on processing issues in Atlantic Canada over the past few years, there has been one significant program change which has resulted in a variety of tax planning issues which we will address. The program change which we are referring to resulted in a situation which most farms are not overly accustomed to nor prepared to deal with - the arrival of excess cash above and beyond that required for operations. The program change to which we are referring is the adoption and implementation of the Canadian Agricultural Income Stabilization (CAIS) program and the wind down of the Net Income Stabilization Account (NISA) program under the *Farm Income Protection Act* (Canada).

Previously farm tax planning around NISA accounts was focused on multiplying the number of qualifying shareholders in a family farm corporation to maximize contribution room. With the change in programs the planning focus changed as well. Beginning with the 2003 program year the CAIS program replaced the NISA program and other previous disaster programs such that NISA accounts began to be wound down as of March 31,

2004. Under the NISA program farmers had both a NISA Fund 1 and a NISA Fund 2 where NISA Fund 1 was made up of contributions by the farmer to their account and NISA Fund 2 was made up of government contributions to the farmer's account. NISA Fund 1's were non-taxable, while NISA Fund 2's were taxable as income if received by the farm taxpayer in a given year. Originally on the wind down of the NISA program, the government permitted the transfer of NISA Fund 1 money into the CAIS program accounts, but this option ran out shortly after the establishment of the program. Following that, farmers were left with the option of either withdrawing all of the funds in their accounts immediately or withdrawing the funds over a period of up to five years such that multiple payments could be made up to March of 2009. This was to permit the orderly closure of NISA Fund accounts while minimizing the Income Tax impact on the farm taxpayer as they collapsed what, in many circumstances, were significant cash assets. For many former NISA program participants this has meant that significant sums of cash not required for operations have found their way back into farm taxpayer accounts and investments. For these farmers this has oftentimes resulted in significant tax planning issues.

For the tax advisor who is reviewing the status of a farm operation, one of the key issues will always be to ensure that non-active assets, such as cash or investments, are at appropriate levels and if there is the risk that the appropriate levels could be exceeded, then to advise regarding methods for maintaining the levels as required. The farmer who carries on their business either through a corporation or partnership or as a sole proprietor has access to the \$750,000 capital gains exemption where all or substantially all of the fair market value of the property of the business is used principally in the course of carrying on the business of farming per subsections 110.6(2) and (2.1) of the *Income Tax Act* (Canada). Although there has been some caselaw which has indicated otherwise, generally this reference to "all or substantially all" has meant that 90% or more of the assets must be

active and not fall into the inactive category which would include these cash or investments. Tax planners, therefore, have been focusing on the arrival of these NISA funds in the corporations to ensure that they are dealt with accordingly in light of this concern. Obviously, certain farm taxpayers have simply dealt with the issue by retiring long term debt which is not uncommon in our farm operations. Others have, however, had to address the issue in terms of purifying the farm business or in terms of providing mechanisms for on-going purification. We will discuss this planning in more detail below.

These excess non-active assets have also caused issues for tax planners in terms of their effecting the status of the farm business as a Small Business Corporation as defined at subsection 248(1) of the *Income Tax Act* (Canada). Those farm taxpayers operating their business through a family farming corporation and who wish to split income with their spouse (or other designated persons as defined at subsection 74.5(5), but beware the Kiddie Tax at subsection 120.4 of the *Income Tax Act* (Canada)) are also required to maintain their corporation as a Small Business Corporation. If the above tests are not met, then the corporate attribution rules at subsection 74.4 of the *Income Tax Act* (Canada) shall apply to attribute the income paid to the spouse or other designated beneficiary back to the farm taxpayer.

In order to deal with this from a tax planning perspective it becomes necessary to complete the above referenced “purification”. Typically this will be achieved, in the corporate setting, by declaring a stock dividend equal to the value of the cash to be removed and then transferring those stock dividend shares to a newly formed corporation pursuant to Section 85 of the *Income Tax Act* (Canada). The cash and investment assets will then be transferred from the farm corporation to the new corporation by asset transfer agreement. Whether or not Section 85 of the *Income Tax Act* (Canada) will be utilized is dependent on whether or not there are inherent gains in the assets to be transferred.

Either a promissory note or, in the case of a Section 85 transfer, shares equal to the value of the cash investments transferred will be issued by the new corporation to the farm corporation as consideration on the transfer. The two corporations will then cross-redeem the shares issued by them to the other (or in the case of a promissory note having been issued then the one set of shares issued by the new corporation will be redeemed for a promissory note) and the corresponding debts evidenced by the promissory notes will be set-off so as to separate the new corporation from the farm corporation. Other more aggressive plans have seen the use of the discretionary dividend shares where the new corporation purchases shares in the farm corporation which permit the payment of a dividend on those shares at the sole discretion of the directors without reference to a stated dividend rate such that the excess cash is simply paid over to the new corporation as a dividend on those shares. Obviously, this type of planning is utilized where there is not a concern over the realization of inherent gains. One must query, however, whether this practice is even legal, given that the dividend would need to be declared out of pre-share issuance profits and given the encroachment on value of existing shareholdings, or at the very least whether the purchase price for the discretionary dividend shares can be set at a nominal value given their immediate return.

Other tax planning considerations which arise generally as part of or following the purification of the farm corporation tend to be related to the structuring of the shareholdings for the farmers' future planning purposes. While the common planning technique might be to freeze off the farm corporation and settle a family trust to enable income splitting and the continued removal of excess cash from the farm corporation through the family trust to the new corporation as a beneficiary of the trust, the relationship of the shareholders of farm corporations can cause some tax planning issues. It is not uncommon to find farm corporations where the shareholders are brothers and sisters, for instance, or where an unrelated party (often a key person) has an interest as

well. In these situations one must consider the application of subsection 55(2) of the *Income Tax Act* (Canada) and possible planning techniques to avoid or minimize its risk of application to your transaction. Where siblings are deemed to be unrelated pursuant to subsection 55(5)(e) of the *Income Tax Act* (Canada) or an unrelated party is involved, one may find themselves outside of the related party exception to subsection 55(2) found at subsection 55(3). One of the techniques utilized to minimize this risk has been the creation of a Redemption Price Reducing Dividend Share where instead of completing the purification by the redemption steps which would result in a deemed dividend under subsection 84(3) of the *Income Tax Act* (Canada) and bring you into subsection 55(2), a dividend is paid on these shares equal to the redemption value of the shares less the paid up capital. These shares contain terms which effectively reduce the redemption value of the shares by the amount of any dividend paid on them. To further minimize risk, these shares, even with their nominal value, can then be left in place between the two companies such that there is no redemption even though it would be equal to the paid up capital.

Finally, whenever one is dealing with an unrelated party, one should consider the potential application of subsection 110.6(8) of the *Income Tax Act* (Canada) if you are considering freezing the shares of the corporation. The Canada Revenue Agency has taken the position that the use of the capital gains exemption may not be permitted on the common shares where it could be argued that a freeze has been completed for the benefit of an unrelated party. This is based on the interpretation that the share would not qualify as a Prescribed Share given the application of Regulation 6205 of the *Income Tax Act* (Canada). Practitioners have taken to transferring the various shareholdings of the farmer and the unrelated party to separate holding companies and then completing any freeze transaction at the holding company level.

Needless to say, where one is considering the reorganization of a farm business, it is indeed necessary to be careful to watch where you step given the rules relative to and relationships which one tends to find in those businesses, particularly if you are faced with the situation where that business is in receipt of the NISA fund withdrawal and now finds itself offside the “all or substantially all” requirement.

Turning now to the fishing industry, we find that there have been significant amendments to the *Income Tax Act* (Canada) which have impacted on the tax planning for fishers. As was indicated previously, these amendments are considered in some detail in John F. Oakey’s paper and should be considered alongside any of the developments and considerations raised in this paper. Indeed, one would have thought that the significant amendments in the *Income Tax Act* (Canada) would have provided a fairly stable tax platform on which to base your plans for fishers where the issues and techniques could be brought over more or less wholesale from our farming experience. Regrettably, however, tax planning for the fishing industry is currently so unsettled and fraught with mines that many practitioners will not even dare to venture out into these waters at this time. It was hoped that by the time of writing this paper that the issues facing tax planners for the fishing industry would be resolved and that suggestions could be made for how to approach your planning for the future. Regrettably, however, the current status of the law is such that it provides for a great many questions but little in the way of answers. We shall, therefore, simply move through where we have been since March of 1999, the changes brought on at July 1, 2003, where we are today and some possible scenarios for the future along with the various tax planning developments and techniques which go with these periods.

The unsettled law to which we are referring comes, as we have indicated, not from the *Income Tax Act* (Canada) but instead is largely policy driven in nature. There has also

been various case law and attempted legislative changes which have impacted on the planning for this industry. This will require us, therefore, to consider matters both from the Fisheries and Oceans side of government and from the Canada Revenue Agency side.

Tax planning for a fisher is quite simple and settled provided you have your sole proprietor fisher with their core status and licenses issued in their name along with their necessary vessel and gear and they are on board to actively fish their licenses. The fisher legally holds and has the benefit of these licenses, reports the income therefrom and is entitled to utilize the various provisions under the *Income Tax Act* (Canada) relative to intergenerational transfers (rollover) and the Capital Gains Exemption where there is qualified fishing property. According to Sections 2 and 16 of the Regulations made pursuant to the *Fisheries Act* (Canada), this fisher is the holder of a document, namely the license, which is the property of the Crown, not transferrable, and which does not imply or confer a right or privilege for that person. Furthermore, that fisher can only hold and fish the license(s) in their name (subject to certain exemptions for medical reasons or on death) and the license may not be issued to a corporation pursuant to the *Fleet Separation Policy* contained in the *Commercial Fisheries Licensing Policy for Eastern Canada 1996*.

The fisher operating their business as a sole proprietor would, for most fleets, have been the norm up until March of 1999 when an internal memorandum of the Small and Medium Enterprises Division of then Revenue Canada began to widely circulate regarding that Department's policy regarding the transfer of fishing licenses to corporations. Contained within that 1999 policy statement was the following:

“... we are currently of the view that such a transfer of rights (to fish under his or her fishing license to a corporation) does not offend public policy, as expressed in the rules established by DFO, nor does the transfer result in a misuse or abuse of the

provisions of the *Income Tax Act*. For these reasons, we accept such transfers as valid for purposes of the *Income Tax Act*.” (wording added)

Based in large part on this policy statement, many tax planners began to assist their fisheries clientele with incorporating corporations and transferring the assets of their fishing business to the corporation. Although it is unclear at this time whether it would have made any difference given today’s climate or the comments made in 2003, the tax planners by and large simply indicated on the T-2057's filed with the Canada Revenue Agency for the Section 85 rollovers that part of the property being transferred was the fishing licenses as opposed to the rights to fish under the licenses. This issue will be considered in more detail later in this paper. Additionally, common tax planning was done then or during subsequent reorganizations to allow for family income splitting through the use of family trusts or direct share ownership and also for the ongoing purification of the fishing companies to extract the excess non-active cash building up during a fairly successful fisheries period. Planning was also done to provide for *inter vivos* intergenerational transfers and on death utilizing the available capital gains exemptions coupled with redemption plans to deal with the balance of the value of the corporation either funded by insurance or not. Some variations on this theme were also put in place such as the EI/shared catch arrangement. Under that planning certain assets, usually those of minimal value such as the \$50,000 worth of gear, would not be transferred to the corporation but would remain the property of the fisher. The fisher would then enter into a shared catch agreement with the corporation agreeing to bring this gear with them on board to contribute it to the fishery in exchange for a percentage of the catch. On settlement the buyer would issue the required percentage of the purchase price to the fisher and the balance to the corporation. Conveniently these percentages were basically set to arrive at a personal claim amount sufficient to receive maximum Employment Insurance benefits.

The legal basis upon which these transactions were completed was based on the legal opinion that these rights constituted property at law and that one could, therefore, have both legal and beneficial interests in this property. This position was supported by various case law relative to the fishing licenses<sup>1</sup>. Resulting from this, therefore, was a practice in the legal documentation of dealing with the fishing licenses by transferring only the beneficial interest in the licenses to the corporation such that legal title remained with the fisher and in their name for Department of Fisheries and Oceans purposes. Typically, although not always, the fisher would then enter into a bare trust agreement with the corporation where they would agree to hold the license, renew it annually and actively participate in the income earning process (which was noted as a requirement in the Canada Revenue Agency policy), but where they would also indicate that control over the license, including dispositions or transfers thereof, and the right to the earnings therefrom would rest with the corporation. This became common practice in the industry and was indeed known by the Department of Fisheries and Oceans to be the practice.

The above planning basically ceased, other than reorganizations of existing corporations or planning for the risk averse who were prepared to go ahead in any event, when the Fishing Industry Specialist from the then Canada Customs and Revenue Agency (from Guelph, Ontario) announced the Agency's new policy that "... licensees are not entitled to transfer their licenses or associated license privileges to a corporation using the provisions of Section 85." and that "If an individual erroneously transferred a fishing license to a corporation prior to July 1, 2003, the CCRA will determine, on a case by case basis, if taxation relief can be offered.". Naturally, this caused some significant concern amongst tax planners and their clients and particularly with those who had already incorporated

---

<sup>1</sup>See most recently for example *Saulnier (Receiver of) v. Saulnier* 2006 NSCA 91, 22 C.B.R. (5<sup>th</sup>) 38, 246 N.S.R. (2d) 239 (N.S.C.A.) leave to appeal to the Supreme Court of Canada granted

their fishing businesses. The potential ramifications of this on a worst case scenario basis have already been reviewed in John F. Oakey's paper referenced above, but which we shall include here again for ease of reference:

- “• Reduction of the redemption value of preferred shares of the fishing corporation that were issued as consideration for the transfer of the fishing licenses,
- Potential 15(2) benefit as a result of an overdrawn shareholder loan resulting from the exempt gains balance on the fishing licenses transferred to the corporation,
- Potential interest on any taxes resulting, and
- Grind down of the adjusted cost base of shares under subsection 69(1) that might have been purchased by a non-arm's length person.”

We are not aware of any such assessments having been issued by the Canada Revenue Agency as of the date of this paper.

Aside from those aforementioned brave souls who were prepared to proceed with incorporating their fishing businesses or acquiring fishing assets with a corporation, the planning changed to focus on how to reap the greatest rewards from a corporate structure while not completing a license transfer pursuant to Section 85 of the *Income Tax Act* (Canada). The most common technique for avoiding this has been to transfer the various fishing assets to the corporation, less the licenses, and then to enter into a lease agreement with the license holder for the use and benefit of the license. The issue of primary concern with this approach was whether the value being paid to the license holder on an annual basis would be considered reasonable, particularly given what arm's-length parties would charge in the marketplace for the lease of their license by other fishers. A variation on this theme was to once again use the shared-catch arrangement where the license would be the

asset retained by the fisher and brought onboard the vessel to be contributed to the fishery such that the fisher could receive a percentage of the catch to qualify for Employment Insurance.

In the meantime, the Department of Fisheries and Oceans have been carrying on consultation with the industry to attempt to once and for all deal with this issue of control and corporations. What became apparent through that process, however, was that the Department of Fisheries and Oceans and many of the fishers appeared to be less concerned with the use of corporations and were far more concerned with the issue of control in the fishery. This brings us to where we are today and to the announcements and correspondence issuing from the Department of Fisheries and Oceans since April of 2007.

In a news release dated April 12, 2007, Fisheries and Oceans Canada relayed that the Minister had announced measures to preserve the independence of inshore fleets in the Atlantic Canada's commercial fisheries. It was indicated that this would generally be accomplished by the elimination of "controlling trust agreements" and by enhanced access to financing. The quote attributed to Minister Hearn was as follows:

"I have long committed to eliminating trust agreements and other license restrictions that undermined the independence of the inshore fleets. These arrangements compromise the ability of fishers to make independent decisions in their own best interests, concentrate the control of licenses in fewer hands, and move the wealth generated from the fishery from those who actually fish."

This reference to control of the licenses in fewer hands and the removal of the wealth from the fishers was essentially referring to a planning technique and practice that had developed of purchasing additional fishing businesses through a corporation or

corporations and having the captain of the particular vessel hold the licenses in trust for the corporation, even though the captain had no ownership interest in the corporation. Utilizing this method, fishers who could previously only ever hold one core group of licenses were now capable of purchasing and receiving the benefit from multiple core groups of the same licenses, such that, for instance, a fisher could effectively have four separate lobster operations and a groundfish operation all being run out of their one company.

Other individuals, typically still involved in the fishery, though not fishers, also sought to take advantage of these techniques and so it also became common for buyers and fish plant owners to acquire the fishing businesses using this corporate structure and the bare trust agreements to control the vessel captains. Aside from the potentially lucrative returns that these operations presented, in the case of buyers and plant owners, it also meant a way of securing a steady supply of the catch which they required for their own businesses. It was, therefore, with a view to eliminating the multiple license holdings and the beneficial ownership of licenses by those other than fishers, that Fisheries and Oceans Canada determined to amend the provisions in the *Commercial Fisheries Licensing Policy for Eastern Canada, 1996*.

Essentially, the proposed amendments to the *Commercial Fisheries Licensing Policy for Eastern Canada, 1996* regarding owner/operator were such that core license holders who met certain conditions would be categorized with a new “independent core” status and would be eligible to receive licenses and renewals thereof. Essentially a fisher with independent core status could hold only one core group of licenses. To accomplish this a draft amendment to the *Commercial Fisheries Licensing Policy for Eastern Canada, 1996* was prepared which provided for a blanket prohibition of “Controlling Agreements”. While the Department of Fisheries and Oceans maintained that those fishers who had

organized their tax and business affairs through corporations would not be affected, a reading of the definition of a “Controlling Agreement” clearly indicates otherwise when coupled with a reading of the fleet separation policy contained in that *Commercial Fisheries Licensing Policy for Eastern Canada, 1996*. No effort had been made to remove the reference that licenses could not be issued to corporations, which would mean that licenses would need to continue to be held in trust by the fisher for the corporation or leased to the corporation as discussed above. A bare trust agreement would by its terms fall under the definition of a prohibited Controlling Agreement which is as follows:

“A Controlling Agreement is an agreement between a license holder and an individual or corporation that permits a person, other than the license holder, to control or influence the license holder’s decision to submit a request to DFO for issuance of a replacement license to another fisher (commonly referred to as a “license transfer”). The definition of Controlling Agreement does not include agreements with recognized financial institutions.”

A fishing license bare trust agreement is in fact an agreement between the fisher as license holder and a corporation that permits a person (namely the corporation), other than the fisher to control or influence that fisher’s decisions regarding the transfer of the license. Such a policy amendment would effectively specifically prohibit the basis upon which transfers of the beneficial interest in licenses have been completed for at least that period of between 1999 and 2003 and in certain cases before and after that as well. As was mentioned earlier, the Canada Revenue Agency had indicated that the T-2057's which were filed generally on the transfer of fishing assets to a corporation indicated that “fishing licenses” were one of the assets being transferred. They indicated that these T-2057's were clearly contrary to the *Fleet Separation Policy* contained in the *Commercial Fisheries Licensing Policy for Eastern Canada, 1996*. Rather a strict comparison of the

two one might suggest in not having regard to the legal agreements on which the forms were based, but perhaps sufficient for the Canada Revenue Agency to issue its revised 2003 policy in light of some of the political pressure that was evidently being weighed upon it by Fisheries and Oceans Canada. One might query whether the policy would have been the same if the forms had submitted that the asset being transferred was the beneficial interest in the rights under the license, but one must suspect that would not have significantly altered the positions.

Following the announcements of the intended amendments to the *Commercial Fisheries Licensing Policy for Eastern Canada, 1996* and the issuance of correspondence several days later from the Regional Director - General Maritime Region of Fisheries and Oceans Canada, Faith G. Scattolon, enclosing a form of Declaration of Core Fisher Concerning Controlling Agreements (which indicated that fishers had until October 31 to submit the Declaration indicating whether or not they were a party to a Controlling Agreement relative to the licenses listed), the Department found itself inundated with submissions from the fishing industry and its advisors relative to the amendments to the policy as had been presented. As of September 5, 2007, the Minister announced that the deadline for submission of these Declarations was being extended by six months to March 31, 2008 to provide the Department with the opportunity to try to resolve some of the issues raised by the fishers and particularly the use of corporations for tax planning purposes.

Through various presentations and correspondence, Fisheries and Oceans Canada has indicated that it was not their intention to adversely impact fishers by negating their ability to utilize a corporate structure so long as the fisher controlled that corporation and that it held only one core group of licenses. Various considerations and arrangements surrounding the eventual outcome of this have been proposed. If Fisheries and Oceans Canada can legally sanction those who maintain multiple license structures, then it would

likely be advantageous and preferable for them to issue the licenses directly to the corporations. Some form of self policing by the fishers who benefit from these arrangements would likely need to be incorporated into the policy amendments such that confirmation of compliance with the policy, likely expressed as an opinion of counsel, could be adopted to permit this form of organization. There has also been commentary that the concern over the control of the wealth generated from the fishery might be an inappropriate one for Fisheries and Oceans Canada to be focusing its attention on. It has been suggested that the mandate of Fisheries and Oceans Canada is for the provision of fisheries resource management and not for that of fisheries income management. If that view does prevail, then it would appear that likely corporate structures and requirements would involve the issuance of one core group of licenses directly to corporations where the fisher owns shares giving them voting control over the corporation. If that is the requirement, then it is interesting to note that voting control shares could be issued in the name of the fisher while all or some of the equity shares in the corporation could be held, for instance, by a fish plant owner or a retired dentist for that matter. Initially, there had been some focus on permitting corporations where the corporations were “family” fishing corporations. Apparently, this has been moved away from likely because of the difficulties in defining “family” and also because of the aforementioned purview of Fisheries and Oceans Canada.

While certain fleets in the fishing industry continue to await clarification on these “owner-operator” policy amendments to be finalized, certain other fleets and issues are reaching a final conclusion for planning purposes. For instance, certain fleets have been exempted specifically from the “owner-operator” policy amendments and will in fact be permitted to have the licenses held directly by the corporation once the Department of Fisheries and Oceans finishes its system programming to allow for these entries in their databases. Examples of this would involve for instance the scallop fleet in southwest

Nova Scotia where there is individual transferable quota. There has been some discussion of providing, however, that multiple licenses and their quota will be stacked at that time, such that only one license will remain, but that it will have all of the quota associated with the previous licenses attached to it. Obviously, this raises some concerns in terms of transferability, but this issue has yet to be resolved. Furthermore, it appears that supply agreements will indeed be permitted where a party enters into a financing arrangement with a fisher and one of the requirements is that the fisher supply all of their catch exclusively to the financier, such as a buyer or fish plant owner. So long as the agreements do not restrict control over the transferability of the licenses and do not contain any right of first refusal, then it appears that these will be permitted.

Regrettably, many fishers are now preparing for a new season with a huge amount of uncertainty surrounding them in terms of their operations, their future plans and whether or not they will be forced to divest themselves of operations which they own; some with potentially significant losses. Obviously, we look forward to some well thought out and complete answers and resolution to the issues discussed above. In the meantime we will wait for Fisheries and Oceans Canada to provide some clarification on and revised amendments to its policies. We will watch to see what happens with the Saulnier case which is tentatively scheduled for hearing on January 23, 2008 by the Supreme Court of Canada, and finally we will also watch to see whether the new *Fisheries Act* (Canada) makes its way back onto the table having died on the table a second time now with the prorogation of the 39<sup>th</sup> Parliament, 1<sup>st</sup> Session on September 14, 2007. Stay tuned.