The Navigator

Selling the Farm and the Capital Gain Exemption

The 2011 Census of Agriculture indicated that nearly half of all farmers in Canada are 55 years of age or older. As such, farm succession planning is becoming more and more important. This article discusses the sale of a farm and the potential use of the capital gain exemption.

Your farm may be your most valuable asset and you may rely upon it to fund your retirement and to achieve other financial goals. If you decide to sell your farm, you may be able to take advantage of the lifetime capital gain exemption. This exemption allows you to receive up to $813,600 (for 2015, indexed thereafter) of your capital gain tax free*. Assuming a marginal tax rate of 45%, this could result in tax savings of $183,000. As such, it is important to understand the criteria for this exemption so that when you sell your farm, you can take advantage of it and maximize the after-tax proceeds of sale. However, if you do not wish to sell your farm property to a third party, and want to transfer it to a family member instead, there may still be significant opportunities for saving tax. These are discussed in the article titled "Transferring Your Farm to the Family".

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from qualified tax and legal advisors before acting on any of the information in this article. (Note: The term "spouse" used in this article also refers to common-law partner or same-sex partner.)

Farms and the Capital Gain Exemption

When an individual decides to sell his/her farm property, the capital gain exemption may be available, no matter which ownership structure is in place. For example, if an individual owns farming assets personally (i.e. no corporate structure is in place), the capital gain exemption may still be available upon the sale of some of these farm assets. This article discusses the criteria required to qualify for the capital gain exemption on the sale of farm property for each ownership structure, as well as other strategies and implications to consider when selling your farming assets.

When is the Capital Gain Exemption Available for Farms?

The capital gain exemption is available to offset any triggered capital gain on the sale of qualified farm property. Qualified farm property is property owned generally by an individual or their spouse that is the following:

* As of 2015, for provincial purposes, the LCGE available in Quebec is $1 million (raised from $ 800,000 previously) on the disposition of qualified farm property or qualified fishing property (or a combination of the two). This amount will not be indexed to inflation but will be maintained until such time as the LCGE available in Quebec on QSBC shares (which is indexed to inflation) exceeds $1 million. At that time, the same LCGE will once again apply to all three types of property (qualified farm property, qualified fishing property and QSBC shares).

The capital gain exemption is available to offset any triggered capital gain on the sale of qualified farm property.

(a) Real or immovable property and eligible capital property used in the course of carrying on the business of farming in Canada generally by:

  i. the individual, their spouse, parent (according to the CRA, this also includes the grandparents and great-grandparents) or child;

  ii. a family farm corporation whose shares are owned by an individual, their spouse, parent or child; or

  iii. a family farm partnership where an interest is owned by the individual, their spouse, parent or child;

(b) Shares of a family farm corporation owned by the individual or the individual's spouse; or

(c) An interest in a family farm partnership of the individual or the individual's spouse.

Additional criteria must be met in order to fall within one of the above categories for tax purposes. These are discussed below.

Sale of Real or Immovable Property and Eligible Capital Property

Farmland and farm buildings are examples of real or immovable property used in farming, whereas milk and egg quotas are examples of eligible capital property used in farming. As indicated above, a capital gain from the sale of real or immovable property or eligible capital property by an individual may be offset by the capital gain exemption if this property is used in the course of carrying on the business of farming in Canada by certain individuals. In order to be considered to be used for this purpose, certain ownership and usage conditions must be met. These conditions are discussed below.

For property purchased after June 17, 1987:

Ownership

For real or immovable property or eligible capital property to be considered used in the course of carrying on the business of farming in Canada, it must have been owned generally by an individual, their spouse, child or parent throughout the period of at least the 24 months immediately prior to disposition.

Usage

To be considered used in the course of carrying on the business of farming in Canada, the property must meet the following usage requirements:

(a) For at least two years during the time the property was owned:

  (i) the gross revenue from farming must have exceeded the total of all other sources of income for the individual, spouse, child or parent; and

  (ii) the property was used principally in a farming business carried on in Canada in which the individual, spouse, child or parent is actively engaged on a regular and continuous basis; or

(b) Throughout a period of at least 24 months while the property was owned generally by the individual, spouse, child or parent, it was used in a farming business by a family farm corporation or family farm partnership in which one of

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these individuals was actively engaged on a regular and continuous basis.

The usage requirements above indicate that the property must be **used principally** in a farming business carried on in Canada generally by the individual, spouse, child or parent who is **actively engaged on a regular and continuous basis.** There are certain requirements to meet this criteria, which are discussed further below.

Used Principally

"Used principally" is typically considered to mean that more than 50% of the property's use is in the business of farming by generally the individual, their spouse, child or parent. Thus, if the farm is leased to tenants or involved in a sharecropping arrangement, the farm property may not meet the "used principally" criteria. These arrangements are generally considered to generate rental income, not farming income. As a result, if the farm is leased to tenants or involved in a sharecropping arrangement for a majority of the ownership period, the assets may not meet the criteria of qualified farm property and the capital gain exemption may not be available when this property is sold.

Canada Revenue Agency (CRA) has provided guidance on situations where farm property was used for both farming and non-farming purposes. CRA has indicated that if the farm property was used principally in the course of carrying on a farming business in Canada for a majority of the period of ownership, then the property will meet the usage requirements. For example, if an individual owned farm property for 20 years, carried on a farming business for 11 of those years and entered into a sharecropping arrangement for 9 years, the individual will meet the requirements of "used principally".

Actively Engaged on a Regular and Continuous Basis

While there is no definition of "actively engaged", CRA has provided some guidance. This requirement is met when generally the individual, their spouse, child or parent is actively engaged in the management and/or day to day activities of the farming business. That person would be expected to contribute time, labour and attention to the extent that their contributions would be a factor in the successful operation of the business.

Guidance on the term "regular and continuous" has been provided as well. Although it is a question of fact, generally an activity that is infrequent or activities that are undertaken frequently but at irregular intervals would not meet the requirement of "regular and continuous". Additionally, if farming is not the chief source of income, it may be more difficult to demonstrate that the individual (or his/her spouse or child) was actively engaged on a regular and continuous basis in the business of farming. Consult your tax advisor as to whether you are considered "actively engaged" in your farming business on a "regular and continuous basis".

If you satisfy the above ownership and usage conditions, you may be eligible for the capital gain exemption when you sell this property. Note that if you have previously claimed the $100,000 general capital gain exemption (eliminated effective February 22, 1994) and/or already used all or part of the lifetime capital gain exemption, the amount of the exemption available for the sale of your farm property will be reduced by the same amount.

For property purchased on or before June 17, 1987:

(i) during the year of disposition, the property must have been used principally in the course of carrying on the business of farming in Canada by the individuals listed under the qualified farm property definition; or

(ii) in at least five years during which the property was owned, it was used principally in the course of carrying on the business of farming in Canada by the individuals listed under the qualified farm property definition.

Please note that if you purchased the property prior to June 18, 1987 and claimed the $100,000 capital gain exemption described above, you have likely been deemed to have disposed of this property (at the time these exemptions were used) and therefore would be subject to the ownership and usage tests for properties purchased after June 17, 1987.

The calculation of capital gain that may arise upon the sale of quotas are quite complex. You should discuss this calculation with a qualified tax advisor.

Sale of Shares of a Family Farm Corporation

You may be able to reduce or eliminate the capital gain arising from the sale of shares of your family farm corporation by using the capital gain exemption. To be considered a family farm corporation, for the purpose of claiming the capital gain exemption , you must meet the following criteria:

(a) throughout any 24 month period ending prior to the disposition, more than 50% of the fair market value of the property owned by the corporation was attributable to:

- (i) property used principally in the course of carrying on a farming business in Canada (in which generally the individual, their spouse, child or parent is actively engaged on a regular and continuous basis) by one of the individuals listed under the qualified farm property definition or the corporation itself;
- (ii) shares of a corporation, where all or substantially all the fair market value of the property was attributable to property listed in (i) above or another family farm corporation or family farm partnership; or
- (iii) a partnership interest, where all or substantially all the fair market value of the property was attributable to property listed in (i) above or another family farm corporation or family farm partnership; and

(b) at the time of disposition, all or substantially all the fair market value of the property owned by the corporation was attributable to property described in (i) to (iii) above.

The information provided earlier regarding the terms “used principally”, “actively engaged” and “regular and continuous basis” also apply to this criteria. There is no gross income test when determining whether shares of a corporation qualify as shares of a family farm corporation.

It is important to note that while the capital gain exemption is available on the sale of the shares of a family farm corporation, the exemption is not available if the family farm corporation sells its farming assets. It is important to keep this restriction in mind when you are thinking about selling the shares of your corporation or having your corporation sell its assets.

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Sale of Assets of a Family Farm Corporation vs. Sale of Shares of a Family Farm Corporation

When negotiating the sale of a family farm corporation, the buyer and seller have to agree on the terms, including whether the buyer will acquire the shares of the family farm corporation or its underlying assets. Typically, a buyer prefers to purchase assets. This is because the assets' adjusted cost base for the buyer will be equal to the purchase price they paid (which will typically be higher than the seller's adjusted cost base for the property) and the buyer will not be responsible for any hidden liabilities that the family farm corporation may have. Sellers, meanwhile, generally prefer to structure the transaction as a sale of the shares of the family farm corporation so that any gain they realize can be treated as capital gain for tax purposes and they will have the potential to minimize or even eliminate any tax liability using the capital gain exemption. Consult with your qualified tax and legal advisors prior to selling the farm assets or shares to determine the best structure.

Sale of an Interest in a Family Farm Partnership

For the purpose of using the capital gain exemption, a family farm partnership must meet criteria similar to those required by a family farm corporation. As mentioned above, the sale of an interest of a family farm partnership is also eligible for the capital gain exemption. If a family farm partnership sells its assets, as opposed to an individual selling his/her interest in the partnership, the capital gain exemption may still be available provided the real or immovable property or eligible capital property used meets the criteria discussed above.

Sale of Other Farm Property

Note that if farming assets are owned personally, the capital gain exemption cannot apply to capital gain realized on the sale of farming equipment, machinery or inventory. However, if these assets are in a family farm corporation, on the sale of the shares, the capital gain exemption may be available. If you are considering the sale of other farm property, discuss the potential implications of such a sale with a qualified tax advisor.

Alternative Minimum Tax (AMT)

Under Canadian tax law, you are required to calculate your tax liability using two tax calculation methods: the regular method and the AMT method, and then pay the higher of the two amounts. This ensures that you are subject to at least a minimum amount of federal tax on your taxable income (before taking specific deductions that significantly reduce or eliminate your tax liability). Essentially, AMT requires a separate tax calculation which adds certain deductions you received back to your regular taxable income. Based on this calculation, you will determine a minimum amount of tax. If this minimum amount is greater than the tax liability calculated normally, the minimum tax amount (the AMT) becomes your tax liability.

You can carry forward the difference between the AMT that you pay and your regular tax liability for seven years. You can then deduct the carryforward amount from your regular tax liability, that exceeds your AMT liability, in the next seven carryforward years or until it is used up.

When you sell your qualified farm property and use the capital gain exemption, you are at risk of triggering AMT. Although you can apply the unused AMT credits in future years, you can avoid triggering the AMT by employing the capital gain reserve strategy. This strategy allows you to defer the capital gain on the disposition of your property over a number of years. Canadian tax rules allow you to spread the recognition of a capital gain, including from the sale of farm property, over a maximum of five years if the sale is structured properly.

You can determine the capital gain reserve by using the following formula:

The Lesser of:

a) $\dfrac{\text{Capital Gain}}{\text{Proceeds of Disposition}} \times \text{Amount payable after the end of the year}$

Or

b) 1/5th of the total capital gain x (4 – number of preceding tax years ending after disposition)

Beginning in the year of sale, you may recognize at least 20% of the original capital gain each year for five years, because of the way the capital gain reserve is calculated. You must recognize the capital gain in full in the year you receive final payment. So, if the purchaser pays you 50% of the purchase price in the year of sale and the remaining 50% in the following year, you may recognize 50% of the original capital gain over two years as you received proceeds over a two year period and the proceeds received each year are greater than 20% of the total proceeds. However, if the purchaser pays you the purchase price over a period longer than five years, for example, an eight year period, you may still recognize the capital gain in full over a maximum period of five years.

For more details regarding this strategy, ask your RBC advisor for the article titled “Capital Gain Reserve” and speak to a qualified tax professional.

Principal Residence Exemption

The capital gain arising from the sale of a principal residence can be reduced or eliminated through the application of the principal residence exemption. If you sell land used principally in a farming business that includes your principal residence, you can still benefit from the principal residence exemption and only part of the gain is taxable. Typically, one half hectare (approximately 1.24 acres) on which your residence is situated is considered to be part of your principal residence.

There are two methods that you can use to calculate the exempt gain when you sell land, used principally in a farming business, which includes a principal residence. You can determine which method is best for you and choose to calculate the exempt gain this way.

The first method involves allocating, on a reasonable basis, the proceeds, the adjusted cost base and any expenses involved in the sale, between your principal residence and the remainder of the farming property. The capital gain is then calculated for both your principal residence and the farm and the gain relating to the principal residence is eligible for the principal residence exemption.

The second method involves determining the capital gain on the sale of your farming property, including your principal residence. You are eligible to subtract $1,000 from the gain and an additional $1,000 for each year after 1971 during which the

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property was your principal residence and you were a resident of Canada. You will need to attach a letter to your income tax return that includes the following: a description of the property that you sold, the number of years after 1971 during which you were a resident of Canada and the farmhouse was your principal residence, and a statement that you sold your farm and are making this election.

Note that farm corporations cannot benefit from the principal residence exemption. When structuring your business, you may wish to keep your principal residence outside your farming corporation so that the principal residence exemption is still available. Additionally, if your farm has two or more homes, only one home can be designated as the principal residence in a given year. Before you sell your farm, discuss the principal residence exemption which may be available to you with your qualified tax professional.

Income Tested Benefits

It is important to note that although the capital gain exemption may reduce or even eliminate the tax liability on the sale of your farm property, the capital gain you realize may still impact your income tested benefits. For example, Old Age Security (OAS) is clawed back if an individual's income is greater than a certain threshold. A taxable capital gain arising from the sale of farm property will be considered income, for OAS purposes, even if the capital gain exemption is used. As such, capital gain resulting from the sale of farm property that have been offset with the capital gain exemption, may still affect your OAS benefits. Ask your RBC advisor for the article titled "Old Age Security and Other Government Income Sources".

Summary

If you are a farm owner, you have access to significant potential tax advantages when selling certain farm assets. Through proper planning, with the help of professional legal and tax advisors, you may be able to realize significant tax savings when selling your farm property.

Please contact us for more information about the topics discussed in this article.