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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES



Transferring your farm to the family

Leaving your farm to your family in a tax-efficient manner

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The 2016 Census of Agriculture indicated that over half of all farmers in Canada are 55 years of age or older. As such, succession planning is becoming very important. The Census also found that in 2016, 8.4% of farms nationally reported having a written succession plan. Among sole proprietorships, 4.9% had a written succession plan compared with 16.3% of family and non-family corporations. If you haven't already done so, it may be time for you to start thinking about succession planning. There are generally two ways to divest of your farm assets, selling to a third party or transferring the farm to family members. This article discusses the mechanisms available to transfer your farm to your family members in a tax-efficient manner. For a discussion of the opportunities to save tax when selling your farm to a third party, ask your advisor for a copy of the article titled, "Selling the Farm and the Capital Gains Exemption".

The term "spouse" used in this article also refers to common-law partner or same-sex partner.

Keeping the farm in the family

Your farm may be your most valuable asset and you may rely on it to fund your retirement and achieve your other financial goals. You may decide to pass your farm to your spouse or children during your lifetime so that they can continue operating what you've built. When doing so, it is helpful to understand there

are strategies to minimize your tax liability and maximize your wealth.

Canadian tax rules allow the transfer of qualified farm property to your spouse or children on a tax-deferred basis. Additionally, you may be able to use your lifetime capital gains exemption (LCGE) when you transfer farm property to certain family members. This article discusses the

tax implications of transferring qualified farm property during your lifetime to your spouse and/or children and includes a brief contrast of how these transfers differ from transfers to other individuals.

Transferring farm property to your spouse

You may rollover certain capital property at your adjusted cost base (ACB) to your spouse, or to a qualifying spousal trust, at any time during your lifetime. Capital property that can be rolled to a spouse includes qualified farm property. Your spouse will receive the farm property with an ACB equal to your ACB or, in the case of depreciable property, equal to your undepreciated capital cost (UCC). This will allow you to defer your capital gain tax and recapture of Capital Cost Allowance (CCA) until your spouse sells the property or passes away.

Qualified farm property that is eligible for this rollover includes land, buildings, machinery, shares of a family farm corporation and an interest in a family farm partnership. Inventory does not qualify for a rollover and if you transfer inventory during your lifetime, you must transfer it at its fair market value (FMV). If you plan to transfer farm inventory to your spouse, and the inventory assets are significant, you may consider transferring these assets over a number of years instead of in a single year. This way, you are able to spread the income over a number of years, and ideally, have it taxed at lower graduated tax rates than you would if you realized the income all in one year. Another strategy could be to transfer the farming assets, including inventory, to a family farm corporation, and then transfer the shares of this corporation to your spouse on a tax deferred basis.

Quotas are another typical farm asset (e.g. milk or egg quotas). You can transfer a quota to your spouse, during your lifetime, at cost, if your spouse acquires all the quotas used in the farm, carries on the farming business and you cease to carry on the farming business.

You may trigger the attribution rules if you transfer the above-mentioned farm property to your spouse at its ACB or at its UCC. When your spouse eventually sells the property, any capital gains or recapture of CCA, generated on the sale of the farm property by your spouse, may be taxable to you.

To avoid the attribution rules, you may sell the farm property to your spouse at FMV. When your spouse sells the farm property, any future capital gain will be taxable to them.

In this situation, you may be able to multiply the LCGE by selling the qualified farm property to your spouse at FMV and allowing the future growth to accrue to your spouse.

At any time during your lifetime, you may transfer certain qualified farm property, such as farmland, an interest in a farm partnership or shares of your family farm corporation, to your child or children, at its ACB or, in the case of depreciable property, at its UCC.

You could use your LCGE to minimize, or potentially eliminate, your tax liability arising from the sale of the qualified farm property to your spouse. When your spouse sells the qualified farm property, they can also use their LCGE to shelter the gain realized upon that sale.

Transferring farm property to a child

At any time during your lifetime, you may transfer certain qualified farm property, such as farmland, an interest in a farm partnership or shares of your family farm corporation, to your child or children, at its ACB or, in the case of depreciable property, at its UCC. Child includes biological children, adopted children, stepchildren, grandchildren, great grandchildren and their spouses who are residents of Canada. Alternatively, you may transfer certain qualified farm property to your child or children at a value between its ACB and FMV, unlike a transfer to your spouse, where you can only elect to transfer at ACB or FMV. If you are electing to transfer the property at an amount that is above ACB, it is important to document the elected transfer price. Speak with a qualified legal/tax advisor regarding this matter.

Similar to the rules for spouses discussed above, the ability to transfer property at cost does not apply to farming inventory.

In order to qualify for the transfer to your children, the following conditions must be met:

- Before the transfer, the property was land, depreciable property or certain intangible capital property of a farming business carried on by you in Canada;
- Your children are residing in Canada immediately before the transfer; and
- The farm property is used principally in a farming business in which you, your spouse or any of your children or parents are actively engaged on a regular and continuous basis.

The requirements above indicate that the property must be **used principally** in farming business carried on in Canada by one of these individuals who is **actively engaged on a regular and continuous basis**. These

conditions are described in more detail in the article titled “Selling the Farm and the Capital Gains Exemption”. Please ask your RBC advisor for this article.

Transferring qualified farm property to a child at a Value between ACB and FMV

When transferring qualified farm property, such as land, an interest in a farm partnership or shares of a farm corporation, to your children, you may consider triggering a capital gain to use your LCGE. This may minimize or eliminate your capital gain tax and your child will receive the farm property at a higher ACB for tax purposes. It may also make sense to trigger a capital gain if you have unused capital losses to offset your gain. Since your children receive your farm property at a higher ACB, they may realize a smaller capital gain when they later dispose of it. This can result in less overall tax being paid by your family. In addition, your children may also have the opportunity to use their own LCGE when they dispose of the property, giving your family the ability to multiply the use of the LCGE.

Note that if you transfer your property to your children at less than FMV, intending to take advantage of the LCGE, they should hold the property for at least three years. If your children sell, or arrange for the sale of the property, within three years of the date of the transfer, you will be deemed to have transferred your property to your children at FMV. This may result in additional tax liability for you and your children. Further, if your children are younger than 18 years old when the farm is sold to a third party, you are deemed to have realized the gain instead of your children.

Estate freeze

To allow your adult children to participate in the operation and growth of your family farm, you may consider implementing an estate freeze. An estate freeze is the term commonly given to a transaction where you lock-in or “freeze” the value of a business, for example, an appreciating family farm corporation, and transfer the future growth of the corporation to other individuals, usually your adult children. You implement an estate freeze by exchanging property that is likely to grow in value (e.g. common shares of the family farm corporation) for other property that has no growth potential (e.g. fixed-value preferred shares of the family farm corporation). An estate freeze may be structured to allow you to retain control of your farm.

For example, let’s assume you have accumulated sufficient wealth such that you no longer require additional growth from your family farm corporation and your adult children are interested in participating in the future growth of the farm. If you simply transfer the family farm corporation shares to them, your children will

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become the controlling shareholders. By implementing an estate freeze, you can retain control by exchanging your common shares of the family farm corporation for preferred shares with voting rights and a redemption value equal to the FMV of the company on the freeze date. Your children can then purchase new non-voting common shares at a very low price. Since your preferred shares have a fixed value, all of the future increase in the value of the farm will attribute to the common shares. The result is that your children will participate in any future growth in the value of the farm business while voting control remains with you. You may also be able to trigger a gain and shelter it with your LCGE when you exchange your common shares.

Freezing the value of your shares may also allow you to plan for the tax that will ultimately be payable upon the eventual disposition or deemed disposition of your property on death because the value of the frozen property and the accrued capital gain on that property are known and will not change.

If you want to maintain control over the growth shares, you may want to consider using a trust to hold the shares you are planning to issue to your children. Your children can be the beneficiaries of the trust. This may provide for flexibility in dealing with the future ownership of the shares. For example, if only one of your children is interested in the farming business, you can direct all of the shares in the trust to be distributed to that child. If you are setting up a trust with your children as beneficiaries, it is important to be aware of the attribution rules. If the attribution rules apply, any income and capital gains earned in the trust could be potentially attributed back to you. Speak with a qualified tax and legal advisor if you are considering using a trust to hold shares of your corporation.

Alternative Minimum Tax (AMT)

AMT aims to bring fairness to the Canadian tax system. It prevents certain high income earners from paying little or no tax as a result of taking advantage of significant tax deductions or earning certain types of tax-preferred income. Some common tax deductions or income that may trigger AMT are tax shelter deductions, interest

expenses and/or carrying charges related to tax shelter loans, the employee stock option deduction, Canadian dividends and capital gains. Ask your advisor for a copy of the article titled, “Alternative Minimum Tax (AMT)” for more information.

When you transfer your farm to your child and trigger a capital gain in order to use your LCGE, you are at risk of triggering AMT. Although you can apply the unused AMT credits in future years, you may be able to avoid or reduce AMT by employing the capital gain reserve strategy. This strategy allows you to spread the recognition of capital gains from the sale of farm property, over a maximum of five years if the sale is structured properly. Please note that a ten year reserve period is provided for a properly structured transfer of farm property to a child.

Considerations when transferring farm assets to children

Before you transfer your farm to your children, give some consideration to whether they are interested in operating your farm. If some of your children are not interested in farming, it may not make sense to transfer the assets to your children in equal shares. Instead, you could transfer the farm assets to the children who have an interest in the business and provide an equivalent of other assets to the non-farming children.

Alternatively, you may want to consider holding the operating assets of your farm in a corporation and holding the farmland in another corporation. By separating the different assets, you can leave the corporation holding the operating assets to your children who are interested in the farming business and leave the corporation with the farmland to the non-farming children.

Prior to implementing any strategy, it is a good idea to discuss farm succession matters openly with your children. Regular family meetings are an important part of farm succession. These will help you determine which of your children are interested in farming and ensure all family members are aware of the succession plan.

Family law planning

In some provinces, family law legislation allows certain assets (or the value of the assets) received as a gift or inheritance, including farm property, to be excluded from the pool of assets subject to division on marriage breakdown. This exclusion may be maintained if the inherited or gifted asset is kept separate from and is not commingled with other marital assets. If you inherited farm assets and transfer part, or all of them to your spouse for tax planning purposes, the assets may no longer be excluded from the division of assets on marriage breakdown. Consult a qualified legal

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professional regarding the family law legislation in the province where you live.

Financing

A key part of your succession plan is financing the change in ownership. Do you require the money now to fund your current lifestyle or at a later date to support your retirement? If you sell the farm assets to your children, think about how much and how soon they can pay you. If you can afford to receive payment over a number of years, the children can avoid a large capital outlay that may be a financial burden to them, and you can take advantage of the capital gain reserve strategy to defer the taxes payable on your capital gain.

The children’s ability to obtain the right financing is a key factor in the successful execution of the succession plan. It can have an impact on the future success of the farming business and is critical in structuring the right deal for you and your children. There are a variety of financing options available. Getting the most desirable financing option depends on the historical and projected financial performance of the farm operation, the business cash flow to support debt repayment, the capital structure of the farm and the assets available as collateral.

Transferring farm property to other individuals

Transfers of farm property to individuals other than your spouse or your children results in a disposition at FMV, whether or not the property meets the criteria of qualified farm property. You may consequently realize capital gains and/or recapture of CCA on such transfers. If the assets transferred are qualified farm property, you may, however, be able to use the LCGE to reduce or eliminate your tax liability.

Income tested benefits

Although the LCGE may reduce or even eliminate the tax liability on the sale of your farm property, the capital gain you realize may still affect 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

is considered income, for OAS purposes, even if the LCGE is used. As such, capital gains resulting from the sale of farm property that have been offset with the LCGE, may still reduce certain government benefits.

Summary

For farm owners who wish to transfer their farm assets to their spouse or children during their lifetime, there are several tax strategies available to minimize the tax burden and create more family wealth. If you would like to take advantage of these strategies, consult with qualified legal and tax professionals to ensure that a transfer during your lifetime meets your financial and personal goals.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide

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legal, tax, or insurance 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 a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.



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