Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Selling the farm and the lifetime capital gains exemption

How you may be able to reduce your taxes on the sale of your farm

Statistics Canada conducts the Census of Agriculture (Census). The latest Census, completed in 2016, indicated that over half of all farmers in Canada are age 55 or over. As such, succession planning is becoming very important. The Census also found that in 2016, 8.4% of farm owners 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 a good time to start thinking about succession planning. There are generally two ways to divest your farm assets, selling to a third party or transferring the farm to family members. This article discusses the sale of a farm to an unrelated third party and the potential use of the lifetime capital gains exemption (LCGE). For a discussion of the opportunities to save tax when transferring your farm to family members, ask your RBC advisor for a copy of the article titled "Transferring your farm to the family."

Any reference to a spouse in this article also includes a common-law partner.

Farms and the lifetime capital gains exemption

Your farm may be your most valuable asset and you may rely upon it to fund your retirement and achieve your other financial goals. If you decide to sell your farm, you may be able to take advantage of the lifetime capital gains exemption (LCGE) regardless of how you've structured the ownership of your farm.

If you own farming assets personally, the LCGE may be available upon the sale of some of these farm assets. If your farming business is incorporated, the LCGE may be

available on the sale of the shares of your corporation. The LCGE may allow you to realize up to $1 million of capital gains on the sale of your farm tax-free. Assuming a marginal tax rate of 50%, this could result in tax savings of $250,000.

It's 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. The rest of this article discusses the criteria required to qualify for the LCGE on the sale of farm property for different ownership structures, as well as strategies and implications to consider when selling your farming assets. Please note that if you used any of the capital gains exemptions in the past, you must reduce your available LCGE by that same amount. In addition, there may be further reductions to the LCGE, as a result of claims for allowable business investment losses (ABILs) or certain other deductions, such as net investment losses. If you believe you qualify for the LCGE, speak with a tax advisor to determine the amount for which you qualify.

Qualified farm property

The LCGE is available to shelter realized capital gains on the sale of qualified farm property when you're a resident of Canada throughout the year. Qualified farm property could be any of the following that is generally owned by you or your spouse:

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

   i. you, your spouse, your parent (this also includes the grandparents and great-grandparents) or your child;

   ii. a family farm corporation where the shares are owned by you, your spouse, your parent or your child; or

   iii. a family farm partnership where an interest is owned by you, your spouse, your parent or your child;

(b) Shares of a family farm corporation owned by you or your spouse;

(c) An interest you own or your spouse owns in a family farm partnership;

(d) Class 14.1 property for the purposes of capital cost allowance (certain intangible capital property, such as production quotas) used by you, your spouse, your parent or your child, or partnership in which you or your spouse has an interest that was used in the course of carrying on the business of farming in Canada.

Land and buildings are examples of real or immovable property used in farming. You may be able to shelter the capital gains realized on the sale of real or immovable property used in farming.

A "child" or "children" includes children, adopted children, stepchildren, grandchildren, great-grandchildren and their spouses who are residents of Canada.

Additional criteria must be met in order to qualify for the LCGE. These are discussed in the sections below.

Sale of real or immovable property

Land and buildings are examples of real or immovable property used in farming. You may be able to shelter the capital gains realized on the sale of real or immovable property used in farming. In order for the property to be considered to be used in farming, certain ownership and usage conditions must be met.

The date you acquired your real or immovable property will determine the rules that apply to establish whether the sale of your property qualifies for the LCGE.

For property purchased after June 17, 1987:

Ownership

For real or immovable property or certain depreciable capital property to be considered to be used in the course of carrying on the business of farming in Canada, it must generally be owned by you, your spouse, or your child or parent for at least 24 months immediately prior to disposition.

Usage

Further, your 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 of either your sources of income for the year or the total of all of your spouse's, child's or parent's sources of income for the year (the gross revenue test); and

   (ii) the property was **used principally** in a farming business carried on in Canada in which you, your spouse, your child or your 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 by you, your spouse, your child, your parent or a partnership (of which you or your spouse owns an interest), the property was used in a farming business by a family farm corporation or family farm partnership in which you, your spouse, or your child or parent was **actively engaged on a regular and continuous basis**.

The bolded terms in this section are discussed further in the following sections.

Used principally

Generally, the term "used principally" is considered to mean that more than 50% of the property is used in the business of farming by you, your spouse, or your child or parent.

If your farm is leased to tenants or involved in a sharecropping arrangement, the farm property is usually considered to generate rental income, not farming income. As a result, if the farm is earning rental income for a majority of the ownership period, it's unlikely the assets will meet the criteria of qualified farm property. In this case, the LCGE will not be available when this property is sold.

Actively engaged on a regular and continuous basis

While there is no definition of "actively engaged", the Canada Revenue Agency (CRA) has provided some guidance. This requirement is met when you, your spouse, or your child or parent is actively engaged in the management and/or day-to-day activities of the farming business. Either you or your spouse, your parent or your child are expected to contribute time, labour and attention to the business regularly and continuously to a sufficient extent that such contributions are a determinant in the successful operation of the business.

The CRA has also provided guidance on the term "regular and continuous". Although it's a question of fact, the CRA has stated that 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 for you to demonstrate that you, your spouse, or your child or parent were actively engaged on a regular and continuous basis in the business of farming. Consult your tax advisor as to whether you're considered "actively engaged" in your farming business on a "regular and continuous basis".

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

You may be able to reduce or eliminate the capital gains arising from the sale of shares of your family farm corporation by claiming the LCGE.

For property purchased on or before June 17, 1987:

For property purchased on or before June 17, 1987, there's no gross revenue test. Only one of the following two conditions are required to be met for the sale of real or immovable property to qualify for the LCGE:

(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 gains exemption described previously, you've 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.

Sale of shares of a family farm corporation

You may be able to reduce or eliminate the capital gains arising from the sale of shares of your family farm corporation by claiming the LCGE. To be considered a family farm corporation, the following criteria must be met:

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

  (i) property that has been used principally in the course of carrying on a farming business in Canada by the corporation in which you, your spouse, or your child or parent is actively engaged on a regular and continuous basis;

  (ii) shares of another corporation, where all or substantially all of the fair market value of the property was used principally in the course of carrying on a farming business in Canada or

another family farm corporation or family farm partnership; or

(iii) a partnership interest, where all or substantially all of the fair market value of the property was used principally in the course of carrying on a farming business in Canada or another family farm corporation or family farm partnership; and

(b) at the time of disposition, all or substantially all (generally understood as at least 90%) of 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's important to note that while the LCGE is available on the sale of the shares of your family farm corporation, the exemption is not available if your family farm corporation sells its farming assets. Only an individual taxpayer may claim the LCGE.

If the shares of your farming corporation are not considered shares of the capital stock of a family farm corporation and therefore, is not qualified farm property, you will not qualify for the $1,000,000 LCGE on its sale. However, your corporation may be considered a qualified small business corporation (QSBC) which may allow you to claim the LCGE on the sale of QSBC shares. The LCGE on QSBC shares is currently less than the LCGE on the sale of qualified farm property. For information, please ask your RBC advisor for an article that discusses the LCGE on the sale of private shares.

Sale of an interest in a family farm partnership

The sale of your family farm partnership interest may qualify for the LCGE if it meets the same criteria as those required on the sale of a family farm corporation. As well, the sale of a farm property by a family farm partnership may also be eligible for the LCGE. If your family farm partnership sells its assets, as opposed to you selling your interest in the partnership, the LCGE may still be available when the property meets the criteria discussed previously.

Sale of Class 14.1 property

Beginning January 1, 2017, the federal government introduced a new class of depreciable property (class 14.1) to replace the eligible capital property (ECP) regime. Class 14.1 generally includes goodwill, licences, franchises, farming quotas of indeterminate duration and some patents. It includes property that was eligible capital property (ECP) before January 1, 2017, and property acquired on or after January 1, 2017, the cost of which would be treated as an ECP under the ECP rules.

The LCGE may shelter the capital gains realized on the sale of this class of depreciable property if the property meets the same ownership and usage tests discussed.

When negotiating the sale of a family farm corporation, the buyer and the seller have to agree on the terms, including whether the buyer will acquire the shares of the corporation or its underlying assets.

Asset sale versus share sale

When negotiating the sale of a family farm corporation, the buyer and the seller have to agree on the terms, including whether the buyer will acquire the shares of the corporation or its underlying assets. Typically, a buyer prefers to purchase assets. If the purchaser buys the assets of your family farm corporation, then there is full cost base in the assets (equal to fair market value) to the purchaser. The purchaser will then be able to depreciate the assets from this value. When the purchaser buys the shares, the family farm corporation generally retains the lower historical tax values of the assets. Therefore, the purchaser will generally discount the share purchase price by the amount of tax savings in future depreciation they are foregoing by purchasing the shares instead of assets. Sellers, meanwhile, generally prefer to structure the transaction as a sale of the shares of their family farm corporation so that any gains they realize may be treated as capital gains for tax purposes. The sellers may be able to minimize or even eliminate any tax liability using the LCGE. The asset sale versus share sale decision will depend on a number of factors, including the ultimate after-tax cash amount to be received personally. To determine the best structure, consult with your qualified tax and legal advisors prior to selling the farm assets or shares of a family farm corporation.

Sale of other farm property

Note that if you own farming assets personally, the LCGE does not exempt capital gains realized on the sale of farming equipment or inventory. If your family farm corporation holds these assets, on the sale of the shares, you may be able to claim the LCGE. If you're considering the sale of other farm property, discuss the potential implications of such a sale with a qualified tax advisor.

Alternative minimum tax

The alternative minimum tax (AMT) provision has been in effect since 1986 as a means to bring fairness to the Canadian tax system. It prevents certain high-income earners from paying little or no tax due to taking certain tax deductions or earning certain types of tax-preferred income. Some common tax preference items that may trigger AMT are tax shelter deductions; interest expenses; and/or carrying charges related to tax shelter loans, employee stock option deductions, the LCGE, Canadian dividends and realized capital gains. For more information, ask your RBC advisor for an article on this topic.

When you sell your qualified farm property and 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 reduce or eliminate 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 10-year reserve period is available for a properly structured transfer of farm property to a child. For more details regarding this strategy, speak to a qualified tax advisor.

Principal residence exemption

When you sell your principal residence, you may reduce or eliminate the tax on the gain through the application of the principal residence exemption if you own the property personally. If you sell land used principally in a farming business that includes your principal residence, you may still benefit from the principal residence exemption that may exempt part of the capital gain. Typically, one-half hectare (approximately 1.24 acres) on which your residence is situated may be considered to be part of your principal residence unless you can prove that you need more land for the use and enjoyment of your principal residence.

There are two methods to calculate the exempt gain when you sell farmland, 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.

If you sell land used principally in a farming business that includes your principal residence, you may still benefit from the principal residence exemption that may exempt part of the capital gain.

The second method involves determining the capital gain on the sale of your farming property, including your principal residence. You then subtract $1,000 from the gain and an additional $1,000 for each year after 1971 during which the property was your principal residence and you were a resident of Canada. You may reduce the gain to nil, but you cannot create a loss.

Note that family farm corporations cannot benefit from the principal residence exemption. When structuring your business, you may wish to keep your principal residence outside of your farming corporation so that the principal residence exemption is still available. Before you sell your farm, discuss the principal residence exemption that may be available to you with a qualified tax professional.

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

Being 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 minimize your taxes and maintain more family wealth when selling your farm property.

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

Wealth Management

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