RBC Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Selling the farm and the lifetime capital gains exemption

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

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

On July 18, 2017 the federal government released a consultation paper proposing a number of strategies which target private corporations with regards to income splitting, multiplication of the lifetime capital gains exemption, holding a passive investment portfolio inside a private corporation, and converting a private corporation's regular income to capital gains.

Generally, effective for 2018 and later taxation years, the government has proposed to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults and limit the multiplication of claims to the lifetime capital gains exemption.

The government is also seeking input on possible measures to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. If enacted, these measures may result in a disincentive for investing passively within a corporation.

The strategies discussed in this article may be affected by the proposed measures in the consultation paper and the accompanying proposed legislation. If you are an owner of a private corporation you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.

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

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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 advisor for a copy of the article titled "Transferring Your Farm to the Family".

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

The federal and provincial tax legislations referenced in this article are current as of June 2017.

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 have 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. This LCGE may allow you to receive of 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 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. 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.

When is the capital gains exemption available for farms?

The LCGE is available to shelter realized capital gains on the sale of qualified farm property when you are 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 whose shares are owned by you, your spouse, your parent or your child; or

  iii. a 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 or your spouse owns in a farm partnership;

(d) 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.

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

Land and buildings are examples of real or immovable property used in farming. Capital gains realized by you on the sale of real or immovable property used in farming, may be sheltered by the LCGE.

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

Sale of real or immovable property

Land and buildings are examples of real or immovable property used in farming. Capital gains realized by you on the sale of real or immovable property used in farming, may be sheltered by the LCGE. In order for the property to be considered to be used for farming, certain ownership and usage conditions must be met.

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

For property purchased after June 17, 1987:

Ownership

For real or immovable property or eligible 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, 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, child 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, child, 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, child, parent was **actively engaged on a regular and continuous basis**.

The bolded terms above are discussed further below.

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 is unlikely that 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, or your spouse, child or parent is actively engaged in the management and/or day to day activities of the farming business. Either you or your spouse, parent or 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.

Guidance on the term "regular and continuous" has been provided as

Please note that if you purchased the property prior to June 18, 1987 and claimed the $100,000 capital gains exemption described previously, 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.

well. Although it is 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, 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 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 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 will be reduced by the same amount.

For property purchased on or before June 17, 1987:

For property purchased before June 17, 1987, there is no gross revenue test. Only one of the following two conditions are required to be met for the sale of real or immoveable 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 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.

Sale of intangible capital property

Beginning January 1, 2017, a new class of depreciable property was created. This class of property generally includes goodwill, 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 eligible capital expenditure under the ECP rules. The ECP regime governed the tax treatment of eligible capital expenditures that are generally of an intangible nature. Eligible capital expenditures include the cost of goodwill when a business is purchased, licenses, franchises and farming quotas of indeterminate duration.

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 above.

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 using 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

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 farm partnership may also eligible for the LCGE.

of carrying on a farming business in Canada by the corporation in which you, your spouse, child or parent is actively engaged on a regular and continuous basis;

(ii) shares of another corporation, where all or substantially all 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 farm partnership; or

(iii) a partnership interest, where all or substantially all 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 is 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.

Asset sale vs 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 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 their family farm corporation so that any gains they realize may be treated as capital gains for tax purposes and they may be able to minimize or even eliminate any tax liability using the LCGE. 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

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 farm partnership may also eligible for the LCGE. If your farm partnership sells its assets, as opposed to you selling your interest in the partnership, the LCGE may still be available provided that the property meets the criteria discussed above.

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, machinery or inventory. If these assets are held in your family farm corporation, on the sale of the shares, the LCGE 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)

The 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 as a result of taking advantage of significant tax deductions. 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, Canadian dividends and capital gains. Ask your advisor for a copy of the article titled "Alternative Minimum Tax (AMT)".

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 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.

For more details regarding this strategy, speak to a qualified tax professional.

Principal residence exemption

The capital gain arising from the sale of a principal residence may be reduced or eliminated 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.

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 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.

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.

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.

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 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 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 affect your OAS benefits.

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.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article 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 a qualified tax advisor before acting on any of the information in this article.

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