AG-Succession

Succession Planning in Agriculture

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Transferring Farm Property

The purpose of the Ag-Succession series of factsheets is to provide an objective overview of the issues and options related to succession planning. This information should not be a substitute for using a lawyer, accountant or financial planner to help you make a thorough assessment of your specific operation and situation.

Changing the Rules

There are a number of special rules in the *Income Tax Act* to alleviate the tax burden of selling or transferring a farm and the assets of a farming business. Proper tax planning helps ensure you benefit from these rules upon the sale or transfer of farm property. Recent amendments to the *Income Tax Act* serve to limit some of the tax planning that was previously available. This article reviews the rules regarding the transfer of farm property to the next generation and examines the new amendments that affect tax planning.

The Basics

Normally, if an individual sells or gives property to family members, other than a spouse, they are considered to have "deemed" or sold the property for its fair market value. As a result, they have to recognize a capital gain on the difference between the original cost and the property's current value. The taxable portion of a capital gain is 50 per cent, meaning 50 per cent of the capital gain is subject to tax at the individuals applicable tax rate.

Special rules exist which avoid the basic rules if the property is used in a farming business and transferred to a child, grandchild or great-grandchild (including a spouse of a child or child of a spouse). These special rules are referred to as the "rollover" rules.

Relevant sections of the Income Tax Act

- Section 38 – taxable capital gains
- Subsection 69(11) – inadequate consideration

Transfers Using the Rollover Rules

The rollover rules for farm property are specific and complex. However, if the rollover rules are available in a particular situation, they allow the individual to defer any gains and taxes that would otherwise be payable on transfer.

The rules allow an individual to sell or transfer qualifying farm property to a child or grandchild at any amount between the cost of the property (adjusted cost base for capital property such as land and undepreciated capital cost allowance for depreciable property such as equipment) and the current market value of the property. The amount chosen is accepted as the proceeds of disposition for tax purposes.

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As a result, if an individual chooses the transfer amount to be at cost, no gain will result.

Certain conditions must be met in order to take advantage of this transfer.

The conditions are as follows: the child has to be resident in Canada immediately prior to the transfer; the property must have been used principally in the business of farming prior to the transfer; and, the individual, individual's spouse or any of their children must have been actively engaged on a regular and continuous basis in farming the property.

Property used in a farming business includes land, buildings and equipment located in Canada, shares of a family farm corporation or an interest in a family farm partnership. Farm inventory is not included in this definition.

It is always a question of fact whether property is used in the business of farming.

The Canada Customs and Revenue Agency has confirmed that there is no requirement for the property to be used for farming immediately before the transfer. However, if the property is used for some period of time for some purpose other than farming, a question may arise as to whether the property was used primarily for that other purpose rather than for farming.

Used principally in a farming business, generally means more than 50 per cent of the time. For example, if the property had been farmed for 10 years, rented for five years and then transferred to a child who will actively farm the property, the rollover treatment should be available.

When the rollover applies, the recipient (the child, grandchild, etc.) is deemed to have acquired the farm property for the amount at which the individual was deemed to have sold it. This could be any amount between the cost and the current value of the property.

This means that the gain is eventually taxed in the hands of the child, if the child sells the property at some future time.

Example:

- A farmer decides to transfer farm land to his son. The land cost $10,000 and is currently worth $200,000.

Results

The farmer can choose any amount between $10,000 and $200,000 as the transfer amount. Assuming he chooses $10,000, the capital gain he will report on his tax return is zero (deemed proceeds of $10,000, less the original cost of $10,000).

The son inherits the farmer's cost of $10,000. The gain on the property has now been deferred to the son. If the son were to sell the farm for $200,000, he would report a capital gain of $190,000.

No forms need to be filed if you want to take advantage of this transfer. There may be circumstances where you want to avoid the rollover provision. This could be where you have loss carry-forwards or you want to utilize your $500,000 capital gains exemption.

Relevant sections of the Income Tax Act

- Subsection 73(3) – Inter-vivos transfer of farm property to child

The $500,000 Capital Gains Exemption

Every individual is entitled to a lifetime $500,000 capital gains exemption on qualified farm property. Qualified farm property includes farmland and buildings, shares of farm companies and interests in farming partnerships that meet certain tests. Equipment, inventory and most other assets do not qualify.

In general terms, if you acquired the property before June 18, 1987 and it was used in the business of farming by an individual or a family member of the individual in either the year it is sold or in any five previous years, it qualifies. If the property was acquired after June 17, 1987, the individual must have owned it for at least two years, been engaged in farming on a regular and continuous basis and have earned more gross income from farming than other sources.

When disposing or transferring farm property, it is important to determine whether the exemption applies as it can significantly reduce tax on the capital gain. Use of the exemption can serve to reduce up to $500,000 of a capital gain for an individual.

Since each individual has access to the exemption and farm property may qualify even if certain other members of a family farm it, a common planning techniques is to evaluate whether more that one exemption can be used in the same family.

Relevant sections of the Income Tax Act

- Subsection 110.6(1) - qualified farm property

Making the Most of the $500,000 Exemption

There is a tax planning opportunity to take advantage of multiple capital gains exemptions in one family. The plan involves combining the rollover rules with the capital gains exemption rules.

The rollover rules allow an individual to choose an amount of proceeds between the original cost and the current fair market value. Therefore, if the transfer is structured as sale rather than a gift, a capital gain would result to the transferor.

If the property qualifies and the individual has capital gains exemption remaining, the actual proceeds are set at a desired value whereby the individual can take advantage of the capital gains exemption and eliminate the gain. The child receiving the property would inherit the transfer amount rather than the original cost of the property.

If the property continues to qualify for the exemption and the child has exemption remaining, the child is also able to reduce existing or future gains on the property.

Example:

- Dad owns farmland with a fair market value of $1,500,000.
- The original cost of the land in 1975 was $200,000.
- Dad has actively farmed the land since he purchased it.
- Dad has not previously used his capital gains exemption.
- Dad has two sons who are involved in the farming operation and he would like to transfer land to them as part of his succession planning under the rollover provisions of the Act.
- Two years after the transfer the son's decide to sell the property for $1,500,000.

Results

Sale of land by sons (with no planning)

Proceeds	$1,500,000
Cost	$(200,000)
Capital Gain	$1,300,000
Capital Gains Exemption	$(500,000)
Adjusted Capital Gain	$800,000
Tax on gain (at top Alberta rates)	$156,000

After tax dollars of $1,344,000 (1,500,000 - 156,000) would be available from the sale of the land.

Sale of Land with Prior Planning

- Rather than gifting the property to his sons, dad sells the land to his two sons in exchange for a promissory note.
- Using the rollover provisions of the *Income Tax Act* he is able to choose proceeds between his original cost of $200,000 and the current value of $1,500,000.
- Dad selects $700,000 for his proceeds on transfer to his sons.

Dad (initial transfer)

Proceeds	$700,000
Cost	$(200,000)
Capital Gain	$500,000
Capital Gains Exemption	$(500,000)
Adjusted Capital Gain	Nil
Tax on gain (at top Alberta rates)	Nil

Son #l (sale – 2 years later)

Proceeds (from sale) $1,500,000/2	$750,000
Cost (on purchase from Dad)	$(350,000)
Capital Gain	$350,000
Capital Gains Exemption	$(350,000)
Adjusted Capital Gain	Nil
Tax on gain (at top Alberta rates)	Nil

The same results apply for the second son. The after tax dollars available from the sale will be $1,500,000. The use of the capital gains exemption by dad and the sons has eliminated the tax entirely.

The Trap

Newly proposed provisions in the *Income Tax Act* have been introduced to limit this type of planning.

The new rule will apply where an individual receives property from a related person under the rollover provisions of the Act and then sells the property within three years of receiving it.

If the property is sold within three years, the gain realized on the property is attributed back to the related person who transferred the property.

In the examples above, if the sons were to sell the land within three years of receiving it from dad; the capital gain of $350,000 for each son would have to be reported by dad rather than by the sons. The result is that the taxes payable would be similar to the original result without any planning.

If the sons held the land longer than three years, the results are the same as with the sale of land with planning.

Relevant sections of the Income Tax Act

- Subsection 69(11) – Deemed proceeds of disposition

Summary

Advantageous provisions for the transfer or sale of farm property to the next generation, such as the rollover rules and the capital gains exemption rules, remain available to use.

Recent amendments to the Act have introduced restrictions for using these provisions together. There remains an opportunity to use the rollover rules followed by the use of the capital gains exemption, but a three-year waiting period must be observed.

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For More Information

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