

Transferring your farm to the family

How to leave your farm to your family in a tax efficient manner



RBC Royal Bank



The following article was written by RBC Wealth Management Services

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 mechanisms available to transfer your farm to your family members in a tax efficient manner.

Your farm may be your most valuable asset and you may rely upon it to fund your retirement and to achieve other financial goals. You may also decide that you'd like to pass your farm to your spouse or children to continue operating what you've built. When doing so, it is critical to understand how to do this in a tax-efficient manner so that you minimize your tax liability and maximize your wealth.

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.)



You can transfer qualified farm property to your spouse or to a qualifying spousal trust at any time during your lifetime on a tax-deferred basis.

Keeping the farm in the family

Canadian tax rules allow the transfer of qualified farm property to certain family members to occur on a tax-deferred basis. Additionally, you may be able to use your capital gain exemption when you transfer farm property to your family members. This article discusses the different options you have when transferring your farm to your family members and the potential implications of employing these options.

A number of opportunities, with differing tax implications are available to you, depending on the person to whom you choose to transfer your farm property. This article discusses the implications of transferring farm property during your lifetime to:

- Your spouse;
- Your child or children; or
- Other individuals.

Transferring farm property to your spouse

The tax rules allow an individual to transfer capital property to their spouse at its adjusted cost base (ACB) or, in the case of depreciable property, at its undepreciated capital cost (UCC).

As such, you can transfer qualified farm property to your spouse or to a qualifying spousal trust at any time during your lifetime on a tax-deferred basis. Your spouse will receive the farm property with an ACB equal to your ACB and there will be no immediate tax implications to either of you at the time of the transfer. This will postpone the taxes payable on any capital gain and recapture of Capital Cost Allowance (CCA) until your spouse sells the property.

The type of farm property that qualifies for this rollover includes land, buildings, machinery, shares of a family farm corporation and an interest in a family farm partnership. It is important to note that 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 and resulting tax liability over a number of years. 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.

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.

If you transfer the above-mentioned farm property to your spouse at its ACB or at its UCC, the attribution rules will generally apply when your spouse eventually sells the property. As such, any capital gain generated on the sale of the farm property by your spouse will be taxable to you. To avoid any attribution, you could sell the farm property to your spouse at FMV. When your spouse sells the farm property, any future capital gain will be taxable to him or her.

In this situation, you may be able to multiply the capital gain exemption by selling the qualified farm property to your spouse at FMV. You could use your capital gain exemption to minimize, or potentially eliminate, your tax liability arising from the capital gain on the sale of the qualified farm property. Then, when your spouse sells the qualified farm property, they can also use their capital gain exemption to shelter the gain realized upon that sale.

You could also elect to transfer certain farm property to your spouse at fair market value. This would trigger a capital gain for you on the transfer and you could use your capital gain exemption or your net capital losses to offset this gain. This could also be done on a property by property basis (e.g. some property could be transferred at ACB and other property could be transferred at FMV). However, if your spouse does not pay FMV for this property, the attribution rules above would still apply.

Please note that this does not apply to eligible capital property, such as farm quotas. For these assets, you cannot elect to transfer to your spouse at fair market value.

Transferring farm property to a child or children

You can also transfer qualified farm property to children on a tax-deferred basis at any time under certain conditions. For the purposes of this discussion, a 'child', or 'children' includes children, adopted children, stepchildren, grandchildren, great grandchildren and children-in-law. Using this transfer, you can defer the taxes payable on the capital gain and recapture of CCA

until the child or children sell the property. In addition, you may be able to transfer your qualified farm property to your child or children at a value between its ACB and FMV, unlike a transfer of your qualified farm property to your spouse, which you can only do at either its ACB or FMV in most instances.

Similar to the rules for spouses discussed above, the rollover provisions do not apply to farming inventory transferred to a child. Also, eligible capital property used in a farm can be transferred at an amount between 4/3rds of the proportion of the cumulative eligible capital and the FMV of the asset. However, the tax implications of this transfer are complex. Consult your qualified tax advisor for advice.

You may be able to benefit from a tax-deferred rollover of land, depreciable property or eligible capital property to a child or children if the following conditions are met:

- The property was, before the transfer, land, depreciable property or eligible capital property of a farming business carried on by you in Canada;
- The child or 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.



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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**. There are certain requirements to meet this criteria which are discussed in the article titled “Selling the Farm and the Capital Gain Exemption”. Please ask your RBC advisor for this article.

Generally, the tax deferred rollover of an individual’s qualifying shares of a family farm corporation or a qualifying interest of a family farm partnership to a child or children is available as long as the child or children were residing in Canada immediately before the transfer.

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

When transferring qualified farm property to your child, you may want to consider triggering a capital gain to use your capital gain exemption. This may allow you to minimize, or even eliminate, your capital gain tax and allow your child to receive the farm property at a higher ACB for tax purposes. You may also wish to trigger a capital gain if you have unused capital losses to offset your gain. If your children receive your farm property at a higher ACB, they may realize a smaller capital gain when they later dispose of it. This means less total tax paid by you and your children. Plus, your children may also have the opportunity to use their own capital gain exemptions when they dispose of the property, giving your family the ability to multiply the use of the capital gain exemption.

Note that if you transfer your property to your children at less than FMV, intending to take advantage of the capital gain exemption, 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 will trigger additional tax liability for you and your children will only be able to realize growth, from a tax perspective, from the date of transfer.

Estate freezes involving farm family corporations

There may be situations where you want your children to participate in the operation and growth of your family farm corporation, but they may be too inexperienced to run a farm. In such a scenario, one potential solution is for you to implement an estate freeze. An estate freeze is the term commonly given to a transaction where you lock-in or “freeze” the value of appreciating assets and transfer the future growth of the assets to other individuals, usually family members. You implement an estate freeze by exchanging property that is likely to grow in value for other property that has no growth potential.

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 young 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 become the controlling shareholders. You may not want this to occur if they are not ready to fully operate the farm on their own. You have the option, instead, of 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. Your children can then subscribe for non-voting common shares at a nominal value. By reorganizing your family farm corporation this way, your children can participate in any future growth in the value of the farm business while voting control remains with you. This strategy also enables you to trigger a gain and use your capital gain exemption on the exchange of the common shares.

For more information on estate freezes and the advantages of this strategy, please ask your RBC advisor for the article titled “Estate Freeze”.

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Alternative Minimum Tax (AMT)

Under Canadian tax law, you are required to calculate your tax liability using two tax calculation methods, the regular and the AMT method, and to pay the higher of the two amounts calculated. If you transfer your farm to your child and trigger a capital gain in order to use your capital gain exemption, you may be subject to taxation under the AMT rules. Depending on the province where you live, this could trigger taxes payable of approximately \$40,000 even if you apply your full lifetime capital gain exemption.

You may be able to use the capital gain reserve strategy to minimize AMT. This strategy allows you to defer capital gain on the disposal of your property and spread the tax liability over a number of years. Generally, the maximum period over which a reserve can be claimed is five years. However, a 10 year reserve period is provided for the transfer of family farm property to a child. This strategy allows you to structure the transfer of the farming assets to your children over a ten year period and recognize only 1/10th of the capital gain each year for the next ten years. This will allow you to spread the gain over a ten year period which may reduce or eliminate the impact of AMT.

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, to provide an equal or fair estate distribution to the non-farming children, name them as beneficiaries of another asset, your life insurance policy, for example. 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.

Another possible solution to equalize the distribution between your children is to transfer the farming assets to the 'farming' children subject to a payment or charge payable to the 'non-farming' children. The value of the charge would be an amount reflecting what you consider to be a fair distribution between your 'farming' and 'non-farming' children. This amount would often take into account such factors as the embedded tax liability of the farming assets, the ability of the farming operation to make the payments and the availability of non-farming assets to the 'non-farming' children. You, as the testator, can set the terms of payment. Review the tax implications of such a strategy with your qualified tax professional.

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 generally be maintained if the inherited or gifted asset is kept separate and is not commingled with other



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Financing

A key part of your succession plan is financing the change in ownership. If you sell the farm assets to your children, think about how much consideration you will require from them. You may require the money to fund your current lifestyle or your retirement. If you sell the farm assets to your children, you may choose to receive payment over a number of years. By using this strategy, the children can repay you according to the terms you have agreed and you can take advantage of the capital gain reserve strategy to minimize the taxes payable.

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 farm 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 will depend 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.

Bank financing is typically the most affordable and the easiest to acquire. It is available through operating loans, to finance input costs, inventories and accounts receivable, terms loans to finance machinery and equipment and/or quota and farm

mortgages to finance land and buildings. Talk to an RBC farm finance specialist in the early stages of building your succession plan. They will be well positioned to provide you, or a potential purchaser of your farm, with advice and financial solutions to meet your changing needs.

Transferring farm property to other individuals

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

If you transfer your property to an individual where no rollover is available and the consideration you receive on the transfer is below FMV, there is the potential for double taxation. You will be taxed as if you had disposed of the farming assets at their FMV. However, the ACB of the assets for the recipient will be equal to the amount they paid (which in this situation, would be lower than FMV). This may result in double taxation when the individual eventually disposes of these assets.

Income tested benefits

It is important to note that although the capital gain exemption may reduce or even eliminate all the tax related to the capital gain you trigger on the transfer of your farm property, the capital gain you realize may still have an impact on income tested benefits, such as Old Age Security. Ask your RBC advisor for the article titled "Old Age Security and Other Government Income Sources".

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Summary

There are several tax strategies available to farm owners who wish to transfer their farm assets to their spouse or children during their lifetime. If you would like to take advantage of these strategies, consult your qualified legal and tax professionals to ensure that a transfer during your lifetime is done in a tax-efficient manner.



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