Your Farm. Your Family. Your Future.

Tax and Succession Expertise for Generations

Volume 20

A Cautionary Tale: DIY Income Splitting With Children

– Wealth Planning Group

Christmas was filled with surprises for the Jones family a couple of years ago. On Christmas morning, Amy, Brad and Crystal, ages 21, 17 and 15, woke up to find a silver envelope for each of them under the Christmas tree. Each envelope contained a cheque from their parents for $50,000, 10 common shares of Disasterco (their parents' data recovery business), and a cheque for $100,000 from Disasterco with the word "Dividends" written on the subject line. Christmas was especially good that year! Or so they thought…

Disasterco had experienced an exceptional year and was flush with cash. Already in the highest tax bracket, Bill and Sue wanted to devise a strategy to reduce their personal income by allocating some of the income to their children.

Bill and Sue founded Disasterco 20 years ago and estimated its value at $5,000,000. Each owned 50 common shares of the business. On a whim, a few days before Christmas, they each gave 5 of their shares to each of Amy, Brad and Crystal. Immediately after the gifts were made, dividends were declared and cheques were made out to the children.

Many months after tax returns were filled, the entire family was audited by the CRA. They were reassessed on the following grounds:

Deemed disposition on gift of shares

When you gift assets to a child (other than qualified farm or fishing property), you are deemed to dispose of those assets at fair market value. Bill and Sue had gifted a total of 30% of a $5,000,000 company. Since the cost base for their shares was nominal, the capital gain triggered on the gift was approximately $1,500,000, and a combined tax bill of over $500,000!

Income attribution on funds gifted to minors

Investment income earned on the $50,000 cash gifts to the two minor children is attributed back and taxed in Bill and Sue's hands. Attribution generally does not apply on capital gains earned on funds gifted to minors, nor does it apply to second generation income (income earned on income that was subject to attribution).

Kiddie tax on dividends paid to minors

Kiddie tax normally applies when a minor child receives dividends from a private corporation. It overrides income attribution, so the $100,000 dividend would be taxed in each minor's hands and would be taxed at the highest personal tax rate, with little or no offset for other tax credits and deductions. This could result in over $40,000 in taxes to each minor child.

Corporate attribution as a result of the share transfer

Thankfully this did not apply – but it would have if Bill and Sue had exchanged some of their shares for a different class of shares, which were then gifted to the children. Income splitting strategies through a corporation must be carefully implemented or corporate attribution may apply, which can trigger extremely punitive tax consequences. There are certain exceptions and planning strategies available to negate the effects of corporate attribution but they are complex and require specialized advice.

Always seek advice from qualified professionals before implementing income splitting strategies. Proper tax planning strategies can help you achieve tax savings and avoid costly mistakes. ■

Death of a Farmer

– Thomas Holmes, CPA, CA
Regional Vice-President, Wealth Planning

The death of a farmer can lead to a significant tax liability and an overall complicated situation if proper planning is not undertaken.

As is the case with all Canadian taxpayers, on death, an individual is deemed to dispose of all capital property at fair market value (FMV). This deemed gain is reported on the taxpayer's final T1.

In many cases, a large portion of a farmer's net worth will be capital property (e.g. land) which means that the deemed disposition of capital property triggered on death will result in a substantial tax liability.

Rollover Provisions

One potential strategy to minimize tax on death includes the use of certain tax-deferred rollover provisions. All capital property can be transferred at its adjusted cost base (ACB) to a spouse. And, if certain criteria are met, qualifying farm property (i.e. farm land, farm corporation shares, and farm partnership interests) can be transferred to the following persons at any amount between the property's ACB and FMV:

- spouse/common-law partner
- a qualifying trust
- child/grandchild/great-grandchild
- parent

Transferring the property at ACB defers any tax inclusion thus minimizing the tax on death. In certain circumstances it may make sense to elect to transfer the property at an amount greater than the ACB to take advantage of existing tax balances.

For example, if the deceased has loss carry-forwards to be utilized or an existing lifetime capital gains exemption balance, it would make sense to elect at an amount above ACB and trigger a capital gain to utilize those balances. By doing so, tax would still be sheltered, but the transferee would receive the property with a higher ACB, thus reducing future capital gains related to the property.

When transferring property to a spouse at an amount greater than ACB, it is necessary to formally elect out of the automatic rollover at ACB by attaching a letter to the final tax return.

Planning with Testamentary Trusts

A testamentary trust is a trust that is created on death as a result of a will. A testamentary trust may be a spousal trust, provided certain requirements are met. For farm property to be eligible to be rolled into a spousal trust at ACB certain criteria must be met. One of those criteria is that the trust must be established solely for the benefit of the spouse. Since no children can be beneficiaries of the trust, income splitting opportunities are reduced.

One planning opportunity when utilizing a testamentary trust would be to elect to transfer the property into the trust at FMV. By doing so the restriction to only have the spouse as a beneficiary would be eliminated and both the spouse and children could be included as beneficiaries.

With the spouse and children as beneficiaries any income earned by the farm property held within the trust could be split among the beneficiaries and potentially minimize taxes going forward.

Alternative Minimum Tax (AMT)

In previous editions we have highlighted the application of AMT in situations where a farmer has sold property and claimed their capital gains exemption. It is important to note, that AMT does not apply on returns filed in the year of death. Therefore, if the decision is made to elect out of the rollover and transfer property at above ACB in the year of death (e.g. to claim the capital gains exemption), AMT will not be an issue.

Cash Basis Implications

In situations where a taxpayer has income that has been earned, but not yet received at the date of death, a separate "rights and things" return can be filed. This return is treated as a separate taxpayer and therefore creates a new set of marginal tax brackets to utilize. One situation where utilizing this return can save significant taxes is when a farmer who utilizes cash-basis reporting dies.

At death, the following items can be included on the rights and things return of a deceased cash-basis farmer:

- Payments due for grain shipped
- Deferred grain tickets
- Inventory (livestock or grain)

If these items are not included on a separate return, they would be taxable on the deceased's final tax return or taxable in the hands of a beneficiary. Including these amounts on a separate rights and things return will often result in lower taxes payable as they will be taxed in the lower brackets first.

In situations where the farmer had added back inventory for tax purposes in the year prior to death, the deduction can be made on the rights and things return to offset any potential inventory inclusion or on the final tax return, whichever creates the most benefit.

Conclusion

As always, when navigating the complex tax rules that govern farming, it is important that you consult your professional advisors to ensure the best result for your tax and estate planning needs. ■

Call your Assante Ag Group Advisor to learn more about Corporate Class funds that help defer and minimize tax on investment income, and can also result in retirement income being taxed at preferential dividend and capital gains rates.

Financial Matters for Farmers – An invitation from the Assante Ag Group

Initial Introduction

We provide a free initial consultation to introduce our Wealth Management Program and to review your investment portfolio and financial situation for opportunities and income tax strategies.

What Our Clients Can Expect

- Comprehensive financial planning encompassing tax, insurance, estate, and succession planning based on your long-term goals while still providing for the short-term needs of you and your family
- A personal investment plan based on your goals, tax situation, income requirements, and risk tolerance
- Access to tax lawyers, accountants, and insurance, estate and investment specialists
- Identification, explanation and coordination of tax and estate planning strategies to be implemented by your professional advisors
- Ongoing monitoring of your investments and regular reviews of your financial, tax, and estate plans

Assante Ag Group

The Assante Ag Group is a national farm advisory group that assists Canadian farm families in the areas of tax planning, retirement planning, and wealth transfer. The Ag Group consists of highly experienced and trusted Wealth Advisors as well as lawyers and accountants with knowledge and experience in the tax and estate planning issues that affect farmers.

Taxation represents the single largest expense and loss of capital in the lives of many farm families, particularly in the retirement phase. Members of the Assante Ag Group work directly with the farm family to help them understand the complex tax and financial issues that need to be addressed in order to minimize loss of farm wealth when important transitions or transactions occur.

Tax, Financial and Estate Planning

The Ag Group's main focus and strengths are tax minimization, wealth planning and estate planning, including:

- Planning for the tax efficient transfer of the family farm to the next generation;
- Pre-retirement planning for the tax efficient sale of farm equipment, inventory and other assets;
- Planning tax efficient business structures for the family farm and other ventures;
- Personal tax and estate planning;
- Financial and retirement planning.

The Ag Group brings together not only tax, estate and financial planning, but also tax efficient managed wealth solutions and insurance strategies, all personalized to meet the unique needs and values of each client family.

Coordinating Professional Advice

The busy lives of farm families can seem further complicated by the necessary involvement of professionals from various disciplines, such as accountants and lawyers. The Ag Group provides a comprehensive plan that coordinates the services of these professionals. The Ag Group creates the plan, helps coordinate its implementation by the client family's accountant and lawyer, and continues to monitor the client family's tax and financial affairs thereafter and through the retirement years.

Our Commitment to Farm Families

The Assante Ag Group is committed to maintaining the high levels of proficiency and expertise required to provide professional advice throughout our long-term relationships with Canadian farm families. ■

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