REFERENCE GUIDE

Tax Planning For The Transfer Of Your Family Farm During Your Lifetime

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If you own a family farm and are considering transferring it during your lifetime, you may need to address a number of issues relating to the transfer.

This reference guide highlights some of the tax issues you should consider and summarizes some of the tax exemptions and rollover provisions available to individuals who want to transfer their farming business to the next generation during their lifetime.

The information and commentary in this reference guide are of a general nature, to highlight the importance and benefits of planning farm transfer transactions ahead of time. As this is a very complex area, this reference guide does not provide comprehensive information nor does it cover all situations. As each situation will be unique, you should seek advice from a tax professional who is knowledgeable in farm-related tax matters, prior to transferring any farm property.

Rollovers

A rollover provision permits property to be transferred between certain persons without incurring an immediate capital gain, capital loss, recapture of capital cost allowance (CCA) or terminal loss. Instead, the tax is deferred until the person to whom the transfer is made (the transferee) disposes of the transferred property or is deemed to have disposed of it (for example, on death).

In some cases, it may be preferable to elect not to have a rollover provision apply. For example, you might wish:

- to generate taxable capital gains or a recapture of CCA in order to:
  - fully utilize personal tax credits, charitable tax credits, low marginal tax rates and/or alternative minimum tax credits carried forward from prior years, or
  - to take advantage of losses available from other sources or from prior years that could be applied against taxable capital gains or a recapture of CCA in the year of sale or transfer;
- to generate allowable capital losses, which could be used to offset taxable capital gains realized in the year of sale or transfer;
- to allow a capital gain to be sheltered by the principal residence exemption, the capital gains exemption for qualified farm property, or the capital gains exemption for shares of a qualified small business corporation (QSBC).

Electing out of a rollover provision effectively increases the cost of the property to the transferee, which could reduce the transferee's income tax liability on a future disposition, or deemed disposition of the property. However, electing out of the rollover does not necessarily mean that the transferee will be able to deduct CCA based on the increased cost of the property.

There are several possible rollover provisions that may apply with respect to farm property. These are discussed below.

ROLLOVER TO YOUR SPOUSE

Transferring capital property to your spouse or common-law partner enables you to defer the tax that would otherwise arise.

In general, opposite sex and same sex partners are considered to be common-law partners for tax purposes after a period of 12 months co-habitation.[1] Accordingly, all references to a spouse in this reference guide will apply equally to a common-law partner.

Unless you elect in your tax return for the year of the transfer not to have the spousal rollover apply to the transfer of property to your spouse, your spouse will take over your tax values for the transferred property, and any potential income tax liability will be deferred until your spouse disposes of the property or is deemed to have disposed of it (for example, on his or her death). The election to have the spousal rollover not apply can be made on a property-by-property basis, which allows you to specify which properties will be rolled over to your spouse and which properties will be disposed of at their fair market value.

In order for capital property to be transferred to your spouse on a tax-deferred basis, both you and your spouse must be resident in Canada at the time of the transfer.

Note that it is not necessary for the capital property to have been used in a farming business in order to qualify for the spousal rollover.

Eligible capital property, such as an egg quota, cannot be rolled over to your spouse under this provision.

ROLLOVER TO A SPOUSAL TRUST

You may also defer the tax liability by transferring capital property to a spousal trust (or common-law partner trust) provided both you and the spousal trust are resident in Canada at the time of the transfer.

The following criteria must be met in order for a trust to qualify as a spousal trust for income tax purposes:

- the trust must be created by you during your lifetime

[1] Note that this definition applies only for income tax purposes. Each province and territory also has its own laws governing the rights of common-law partners for other purposes, such as the sharing of property on the breakdown of the relationship.

- your spouse must be entitled to receive all the income of the trust during his or her lifetime, and
- no person other than your spouse can receive or otherwise obtain the use of any of the capital of the trust during your spouse's lifetime.

As with a rollover directly to your spouse, unless you elect in your income tax return for the year of the sale or transfer not to have the rollover apply, the spousal trust will take over your tax values and any potential income tax liability will be deferred until the property is disposed of by the spousal trust, or is deemed to have been disposed of by the spousal trust.

It is not necessary for the capital property to have been used in a farming business in order to qualify for this rollover.

Additional information on spousal trusts is available in our reference guide on spousal trusts.

ROLLOVER TO A CORPORATION

You may defer the tax on income, capital gains and/or recapture of CCA or cumulative eligible capital where you transfer eligible property to a taxable Canadian corporation and certain requirements are met. For example, part of the consideration you receive in exchange for the transferred property must include shares of the corporation and you must file the necessary joint election within the required time period.

Eligible property includes certain capital property, certain types of accounts receivables, certain types of inventory, NISA Fund No. 2 and eligible capital property.

You can choose, within a range of values, what your proceeds of disposition will be and the cost of the property to the corporation for tax purposes. The ability to make such a choice provides you with a planning opportunity since it enables you to decide whether or not, and to what extent, you wish to realize, for example, any income on the transfer.

ROLLOVER TO A PARTNERSHIP

The provisions and rules relating to a rollover of property to a partnership are similar to those applicable to the rollover to a corporation discussed above. In this case, however, the transferee must be a Canadian partnership of which you are a member.

ROLLOVER OF FARM PROPERTY FROM A PARENT TO A CHILD

You may transfer certain farm property to your child, defined as noted below, on a tax-deferred basis provided your child is resident in Canada immediately before the transfer. The farm property eligible for this rollover includes:

- land in Canada
- depreciable property of a prescribed class in Canada
- eligible capital property in respect of a business carried on in Canada.

For the purposes of the tax rules relating to farm businesses, child includes not just your natural child, but also your step-child, adopted child, child-in-law, grandchild and great-grandchild. It also includes a person who, at any time before the person reached the age of 19 years, was wholly dependent on you for support and of whom you had either legal or actual custody and control at the time.

As with the other rollovers discussed above, you can elect within a range of values what your proceeds of disposition will be and the cost of the property to your child.

Prior to the transfer, the assets must have been used principally in a farming business in which you, your spouse or any of your children were actively engaged on a regular and continuous basis.

Farming, as defined in the Income Tax Act, includes the tillage of soil, livestock raising or exhibiting, maintaining of horses for racing, raising of poultry, fur farming, dairy farming, fruit growing, and the keeping of bees, but does not include an office or employment under a person engaged in the business of farming. Other businesses considered by the CRA or the courts to be farming include, for example, tree farming, cattle feed lots and the operation of nurseries and greenhouses.

Factors considered by the Canada Revenue Agency (CRA) in determining whether a particular operation constitutes a farming business include:

- the size of the property used for farming
- the time spent on the farming operation in comparison to the time spent in employment or other income-earning capacity
- plans for developing and expanding the farming operation given available resources
- whether the taxpayer qualifies for some type of provincial farming assistance.

The CRA takes the view that a person will be regarded as being actively engaged on a regular and continuous basis in the business of farming when the person is actively engaged in the management and/or day-to-day activities of the farming business. Ordinarily the person would be expected to contribute time, labour and attention to the business to a sufficient degree that their contributions would be a meaningful factor in the successful operation of the business.

You will be deemed to have used the property in the business of farming if the property was used by a family farm corporation or a family farm partnership in the course of carrying on the business of farming in Canada. However, property used by the child's grandparent in the business of farming and land or buildings leased to someone outside your immediate family for more than 50% of the ownership period will not qualify for the rollover. In the case of a lease, however, you may be able to transfer the land and buildings to a spousal trust on a tax-deferred basis and, after the death of your spouse, it may then be possible to transfer the land and buildings to your child on a tax-deferred basis where the person who leased the land and buildings used them in his or her farming business.

Eligible capital property can only be rolled over to your child during your lifetime. Certain other assets, such as inventory and accounts receivable cannot be rolled over to your child under this provision.

In addition, you cannot use this rollover provision to defer a capital gain on your principal residence where your principal residence is located on farmland and you transfer both the farmland and your home to your child. However, any gain on the transfer of your home may be exempt from tax if the principal residence exemption applies. The principal residence exemption is discussed later in this reference guide.

You may transfer property to a child by way of sale or gift. However, if you want to utilize your capital gains exemption (described more fully below) you must sell the property to your child. In this case, if your actual intention was to gift the property to your child, you could simply take back a demand note from your child as the consideration for the sale, and then provide for the note to be either forgiven on your death or transferred to your child as part of his or her share of your estate.

ROLLOVER OF SHARES IN A FAMILY FARM CORPORATION OR AN INTEREST IN A FAMILY FARM PARTNERSHIP FROM A PARENT TO A CHILD

You may transfer shares of the capital stock of a family farm corporation or an interest in a family farm partnership to your child (broadly defined as noted above) on a tax-deferred basis provided your child is resident in Canada immediately before the transfer.

In order to qualify for this rollover, the shares or partnership interest must meet the specific qualifying requirements set out in the Income Tax Act. For example, one of the requirements is that all or substantially all of the fair market value of the property owned by the corporation or partnership must be attributable to property that has been used by an eligible user principally in the business of farming in Canada in which you, or your spouse, child or parent was actively engaged on a regular and continuous basis.

As with other rollovers discussed above, you can elect within a range of values what your proceeds of disposition will be and the cost of the property to your child.

Note that there is a significant difference between the definitions of a share of a family farm corporation and an interest in a family farm partnership for purposes of the above rollover rules and the definition of those terms for purposes of the capital gains exemption, which is discussed further below.

POSSIBLE RETROACTIVE DENIAL OF A TAX-DEFERRED ROLLOVER TO A CHILD

You should be aware that the Income Tax Act contains an anti-avoidance provision that will retroactively disallow a tax-deferred rollover and instead deem you to have received proceeds of disposition equal to the fair market value of the property. This could arise if the transferred property is sold by your child within three years of acquiring it and if one of the main purposes of the transfer was to take advantage of some deduction or exemption (for example, the capital gains exemption) available to your child. This provision may apply where you have rolled over farm property, shares of the capital stock of a family farm corporation or an interest in a family farm partnership to your child.

Care must therefore be taken to ensure that your child continues to own the transferred property for a minimum of three years in order to ensure that this provision does not apply, since you could incur a capital gain on an otherwise tax-free rollover. In addition, the capital gain may be taxed again when your child disposes of the property since there is no provision that increases the child's cost of the property to the fair market value for tax purposes.

Exemptions

A tax exemption can reduce or eliminate a capital gain on the disposition of a taxpayer's capital property. The following outlines some of the exemptions that may be available on a disposition of farm property.

PRINCIPAL RESIDENCE EXEMPTION

The principal residence exemption exempts gains on the disposition of a personal residence provided certain conditions are met, as outlined below.

Farmers may use one of the following two methods to calculate the gain on a disposition or deemed disposition of their principal residence where that residence is located on farmland:

1. Under the first option, your residence and ½ hectare of adjacent land can be designated as your principal residence. The capital gain would then be exempt from tax. Land in excess of ½ hectare may also qualify but only to the extent that it is established to be necessary for the use and enjoyment of the farmhouse as a residence (for example, your municipality imposes a minimum lot size in excess of ½ hectare or the additional land is needed in order to be able to gain access to your residence). With this option, you must make a reasonable allocation of

the sale price and the adjusted cost base of the property between your residence (including the ½ hectare) and the remaining farmland.

2. Under the second option, you could elect to deduct from the total capital gain on the entire property (your residence and farmland), the sum of $1,000 plus an additional $1,000 for every year since 1971 that the residence was your principal residence.

The capital gains exemption for qualified farm property (discussed below) may be available to shelter any part of the gain on the disposition of the farm property that does not qualify for the principal residence exemption.

Where a taxpayer uses a home partly as a residence and partly to earn business or property income, there is some uncertainty as to how much of the sale proceeds may be sheltered by the exemption. The CRA takes the position that the entire residence may still qualify as a principal residence where all of the following conditions are met:

- the income-producing use is ancillary to the main use of the property as a residence
- the taxpayer did not make structural changes to the property to accommodate the income-producing use
- the taxpayer does not claim capital cost allowance on the property.

If these conditions are not satisfied, then the portion of the home used for the income-producing purpose would be ineligible for principal residence status, and any gain related to this portion of the house would be taxable. However, the portion of the property used as a residence and ordinarily inhabited by the owner would be eligible for the principal residence exemption.

In order for a residence to qualify as your principal residence, you must own the property either alone or in joint ownership with another person (which includes either joint tenancy or tenancy in common). In addition, you, your spouse, your former spouse, or your child must ordinarily inhabit the house in the year.

For the residence to be your principal residence for a particular year, you must designate it as such for each year. After 1981, only one property per family unit (which would include, for example, your spouse or unmarried minor child) can be designated as a principal residence for the year. The designation must be made in your income tax return for the taxation year in which you dispose of the property or are deemed to have disposed of the property.

Where your residence (or farmland on which your residence is located) is rolled over on your death to your spouse or a spousal trust, then the spouse or spousal trust, in determining any gain on a subsequent disposition of the residence, will be permitted to take into account the number of years the residence was your principal residence.

If the residence was used primarily for your personal use and enjoyment, any loss on the actual or deemed disposition of your residence will be deemed to be nil. However, you or your legal representative may be able to claim a capital loss on that part of the farm property which does not qualify as your principal residence.

CAPITAL GAINS EXEMPTION

A $750,000 capital gains exemption (or $650,000 if you had previously claimed the $100,000 capital gains exemption that was eliminated on February 22, 1994) is available to an individual (other than a trust) who is resident in Canada throughout the year and who disposed of qualified farm property or qualified small business corporation shares in the year.

The capital gains exemption for qualified small business corporation shares is discussed in our reference guide on tax planning for the sale of your business.

Note, however, that your ability to claim the capital gains exemption to offset taxable capital gains realized on a disposition of qualified farm property or QSBC shares may be limited by the amount of:

- capital losses in prior years
- allowable business investment losses, or
- any cumulative net investment losses (CNIL) outstanding at the end of the taxation year in which you sell your property. A CNIL account reflects the cumulative amount by which your investment expenses (such as interest and carrying charges on income-producing property (other than business property)) exceed your investment income since 1988. Your CNIL balance must be nil before you will be able to use any portion of your capital gains exemption.

In addition, certain rules provide that the capital gains exemption may be denied where it can reasonably be concluded that a significant part of an individual's capital gain results from the fact that the shares (other than certain prescribed shares) have paid low or no dividends or that dividends paid were less than 90% of the annual rate of return that a prudent investor would expect to receive. These rules are designed to prevent taxpayers from converting dividends into more tax-advantageous exempt capital gains.

Note that if you plan to realize a capital gain on your farm property and claim the capital gains exemption, there are other tax consequences that you may need to consider. For example, you could be subject to the alternative minimum tax or have your Old Age Security benefits and certain tax credits reduced.

Qualified Farm Property

There are specific criteria that must be met for property to be considered qualified farm property. Whether a property meets the requirements for being qualified farm property will depend on a variety of factors including:

- who owns the property
- the type of property being transferred
- what the property was used for and how long the property was so used
- by whom the property was used
- where the property was used
- when the property was acquired by the transferor
- when the property is transferred to the transferee.

The following are the types of property that will constitute qualified farm property if owned by an individual (including a personal trust[2]), the individual's spouse or common-law partner, or a partnership, an interest in which is an interest in a family farm partnership of the individual or his or her spouse or common-law partner:

- real property that has been used by a qualified user in the course of carrying on the business of farming in Canada. A qualified user includes:

  (a) the individual disposing of the property,

  (b) if the individual is a personal trust, a beneficiary of the trust,

  (c) a spouse, child or parent of the individual or of the beneficiary of the personal trust,

  (d) a family farm corporation, a share of which is owned by a person referred to in any of (a) – (c) above, and

  (e) a family farm partnership, an interest in which is owned by a person referred to in any of (a) – (c) above.

  Examples would include land, buildings and leasehold interests in real property such as grazing leases.

[2] Generally, a personal trust is either a testamentary trust or a trust created during life where the beneficiaries have not paid any consideration to acquire their interests in the trust.

- eligible capital property (for example, a poultry or milk quota) used by a qualified user (as described above) in the course of carrying on the business of farming in Canada

- shares of the capital stock of a family farm corporation of the individual or the individual's spouse

- an interest in a family farm partnership of the individual or the individual's spouse.

There are specific conditions that must be met in order for real property and eligible capital property to be considered as having been used in the course of carrying on the business of farming in Canada. The applicable conditions depend on whether the property was last acquired by the individual or partnership before or after June 18, 1987. In general, the conditions that apply for property acquired after June 18, 1987 are stricter.

Real property or eligible capital property (or substituted property) last acquired after June 17, 1987 will only be considered to have been used in the course of carrying on the business of farming in Canada if the following two tests are satisfied:

1. the property (or property for which the property was substituted) was owned by a qualified user or by a personal trust from which the individual acquired the property throughout the 24 months immediately preceding the transfer; and

2. depending on who the user of the property is, either a gross revenue test is met for at least two years while the property was so owned, or a 24-month principal use period test is met.

   The gross revenue test: In at least two years while the property was owned as provided in paragraph 1 above, the gross revenue of the qualified user (or the personal trust) from the farming business in which the property was principally used must have exceeded the person's income from all other sources for the year. In addition, the qualified user (or a beneficiary of the trust) must have been actively engaged on a regular and continuous basis in the farming business in which the property was principally used. The person who meets the gross revenue test does not have to be the person who owns the property.

   The 24-month principal use period test: This test applies where the property was used by a family farm corporation or by a family farm partnership, a share or interest of which is owned by the individual disposing of the property, (or where the individual is a personal trust, a beneficiary of the trust), a spouse, child or parent of the individual or of the beneficiary of the personal trust. In this case, the property must be used principally in the course of carrying on the business of farming in Canada throughout a period of at least 24 months during which time the individual, a beneficiary of the personal trust, or a spouse, common-law partner, child or parent of the individual or beneficiary was actively engaged on a regular and continuous basis in the farming business in which the property was used. The 24-month period of use does not need to be the 24 months immediately preceding the transfer.

As noted above, a less strict test applies in determining whether real property or eligible capital property last acquired by the individual or partnership prior to June 18, 1987 will be considered to have been used in the course of carrying on the business of farming in Canada. In particular, the property must have been used by a qualified user or by a personal trust from which the individual acquired the property, principally in the course of carrying on the business of farming in Canada either:

- in the year the property was disposed of by the individual, or
- in at least five years during which the property was owned by the individual, a beneficiary of a personal trust, a spouse, child or parent of the individual or beneficiary, or personal trust from which the individual acquired the property or a family farm partnership.

Note that the post-June 17, 1987 rules will apply to any property on which you elected to claim the $100,000 capital gains exemption prior to the elimination of this exemption on February 22, 1994 in order to increase the adjusted cost base of real property such as farmland.

Income that will not be eligible for the capital gains exemption includes:

- capital gains realized on the sale or transfer of depreciable property (such as machinery and equipment)
- recapture of depreciation on, for example, buildings, machinery and equipment
- recapture of write-offs on quotas
- income generated from the sale or transfer of inventory.

As noted earlier, the definitions of a share of a family farm corporation and an interest in a family farm partnership for purposes of the capital gains exemption are different than the definition of those terms for the purposes of the rollover rules. The definitions for purposes of the capital gains exemption are as follows:

Share of the capital stock of a family farm corporation

A share of the capital stock of a family farm corporation of an individual (other than a trust that is not a personal trust) at any time is a share of the capital stock of a corporation owned by the individual at that time (the corporate determination time) that meets the following criteria:

1. **24-Month corporate asset test:** Throughout any 24-month period ending before the corporate determination time (the 24-month corporate period), more than 50% of the fair market value of the property owned by the corporation must be attributable to:

   (a) property that was used by:

- the corporation,
- the individual,
- a beneficiary of the trust where the individual is a personal trust,
- a spouse, child or parent of the individual or of a beneficiary, or
- a partnership, an interest in which was an interest in a family farm partnership of the individual, a beneficiary or a spouse, child or parent of the individual or of such a beneficiary (each of the above referred to as a corporate qualified user),

principally in the course of carrying on the business of farming in Canada in which the individual, a beneficiary or a spouse, child or parent of the individual or of such a beneficiary was actively engaged on a regular and continuous basis,

(b) shares of the capital stock or indebtedness of one or more corporations, all or substantially all of the fair market value of the property of which was attributable to property described in 1(c), or

(c) properties described in either 1(a) or (b).

2. Corporate determination time asset test: At the corporate determination time, all or substantially all of the fair market value of the property owned by the corporation must be attributable to:

(a) property that was used principally in the course of carrying on the business of farming in Canada by a corporate qualified user,

(b) shares of the capital stock or indebtedness of one or more corporations, all or substantially all of the fair market value of the property of which was attributable to property described in 2(c), or

(c) properties described in either 2(a) or (b) above.

Ownership of significant reserves of cash or investment assets (non-eligible assets) by a corporation may therefore disqualify the shares of a corporation as shares of the capital stock of a family farm corporation if those non-eligible assets exceed 10% of the fair market value of all assets of the corporation at the time of disposition, or 50% of the fair market value of all assets of the corporation during the 24-month corporate period. The determination as to whether assets are eligible or non-eligible active business assets for the purposes of the tests described above is a question of fact. Such a determination must be made in light of all the facts and requirements of a particular farming business, in consultation with your professional advisors.

Interest in a family farm partnership

An interest in a family farm partnership of an individual (other than a trust that is not a personal trust) at any time is an interest owned by the individual at that time (the partnership determination time) in a partnership that meets the following criteria:

1. **24-Month partnership asset test:** Throughout any 24 month period ending before the partnership determination time (the 24-month partnership period), more than 50% of the fair market value of the property of the partnership must be attributable to:

   (a) property that was used by:

   - the partnership,
   - the individual,
   - a beneficiary of the trust where the individual is a personal trust,
   - a spouse, child or parent of the individual or of a beneficiary, or
   - a corporation a share of the capital stock of which was a share of the capital stock of a family farm corporation of the individual, a beneficiary or a spouse, child or parent of the individual or of such a beneficiary (each of the above referred to as a partnership qualified user),

   principally in the course of carrying on the business of farming in Canada in which the individual, a beneficiary or a spouse, child or parent of the individual or of such a beneficiary was actively engaged on a regular and continuous basis,

   (b) shares of the capital stock or indebtedness of one or more corporations, all or substantially all of the fair market value of the property of which was attributable to property described in 1(c), or

   (c) properties described in either 1(a) or (b).

2. **Partnership determination time asset test:** At the partnership determination time all or substantially all of the fair market value of the property of the partnership must be attributable to:

   (a) property that was used principally in the course of carrying on the business of farming in Canada by the partnership or by a partnership qualified user,

   (b) shares of the capital stock or indebtedness of one or more corporations, all or substantially all of the fair market value of the property of which was attributable to property described in 2(c), or

(c) properties described in either 2(a) or (b) above.

Used principally in 2(a) refers to the use of the asset over the entire period of ownership by the partnership. Therefore, the asset does not need to be used in farming by the partnership or by a partnership qualified user at the time of disposition of the partnership interest.

Reserves

You may wish to claim the capital gains reserve or the farm property capital gains reserve in order to reduce or avoid the claw back of Old Age Security, the payment of alternative minimum tax, the reduction of the non-refundable age tax credit or the loss of income-based assistance such as the Old Age Supplement and Goods and Services Tax Credit.

A capital gains reserve may be claimed where capital property is sold pursuant to an agreement for sale where all or a portion of the purchase price is due and payable after the end of the year of sale. You may claim a reasonable amount, not exceeding 20% of the total gain, as a capital gains reserve for a period of up to five years. However, you cannot claim this reserve if, at the end of the year or at any time in the immediately following year, you were not resident in Canada or if the property was transferred to a corporation that was directly or indirectly controlled by you in any manner immediately after the transfer.

A farm property capital gains reserve may be claimed where:

- the purchaser is your child
- the capital property disposed of was land in Canada, depreciable property of a prescribed class in Canada, a share of the capital stock of a family farm corporation or an interest in a family farm partnership, and
- immediately before the sale, the capital property was used in the business of farming by you, your spouse or your children.

The farm property capital gains reserve may be claimed for a period of up to 10 years and must be a reasonable amount, not exceeding 10% of the total gain.

Conclusion

As the tax rules relating to the transfer of the farm property are very complex, you should ensure that you involve professional legal and accounting advisors who are knowledgeable in this area in your planning.

Note that if you currently do not qualify for a rollover or exemption, it may be possible to undertake certain steps during your lifetime, which could enable you to qualify for a rollover or exemption at the time of a future transfer. You should discuss this further with your professional advisors.

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