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Tax Planning for the Family Farm

Introduction

The family farm continues to serve a special role in the Canadian economy and as such it receives special status under Canada's tax law. In particular, there are two important tax planning strategies that can be used when transferring a Canadian farm property. The Capital Gains Deduction is available to shelter up to $750,000 of capital gains on transfers of *qualified farm property*. The Intergenerational Rollover permits tax-deferred transfers of farm property to other family members. Both strategies can apply to lifetime transfers (i.e. a sale or gift), or to transfers that take place on the death of the owner. The rules surrounding these strategies are very complex and only a general discussion is provided here. As with all tax planning, professional advice is critical to understand the specific implications in your situation.

What is a Farming Business?

For income tax purposes, *farming* includes tillage of the soil, raising or exhibiting livestock, maintaining horses for racing, raising poultry, fur farming, dairy farming, fruit growing and beekeeping. This is not an exhaustive list, and additional activities may be considered farming. However, the lease of property for farming in a *share cropping arrangement* is generally not considered to be farming. Whether a farming activity is considered a business is a further consideration, and will depend on the degree of time and effort expended, amongst other criteria.

Capital Gains Deduction on Qualified Farm Property

A Canadian resident individual has a lifetime Capital Gains Deduction available to shelter up to $750,000 of capital gains on a *Qualified Farm Property* which is reduced for previous capital gain deduction claims by the individual. Qualifying property includes land used in a Canadian farming business or an interest in a family farm business owned through a corporation or a partnership.

There are a number of complex rules relating to this deduction. For example, tests for qualification may include whether the owner is engaged in the business of farming on an active and continuous basis, and whether the farming income was greater than income from all other sources for at least two years. Less onerous tests may apply where the farm property was acquired prior to June 18, 1987. In addition, certain amounts claimed by an individual such as allowable business investment losses, capital losses, interest expenses or other investment expenses (i.e. cumulative net investment losses), may disentitle or defer the individual's right to claim the deduction. Also, other personal tax considerations such as the application of *Alternative Minimum Tax* may result from the use of the Capital Gains Deduction, thereby reducing its benefit.

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Many tax planning strategies are available to obtain optimal benefit from the Capital Gains Deduction. It may be possible to reorganize the ownership of the *Qualified Farm Property* to *multiply* access to the deduction by making it available to other family members in the future. It may also be possible to immediately trigger the use of the deduction without any change in beneficial ownership through a transaction called a *Crystallization*. This would have the benefit of creating an increased tax cost base in the property, thereby reducing the capital gain on a future sale or transfer (eg. at death). Tax planning for the deduction is often combined with an *Estate Freeze* which transfers future growth to other family members (typically on a tax-deferred basis) and limits the tax liability upon the transferor's death to the accrued gain at the time of the freeze. Sound tax planning advice by professionals who have specific expertise and experience is recommended to explore opportunities to utilize the deduction during lifetime, or as part of a tax-efficient estate plan.

The Capital Gains Deduction is separate from the Intergenerational Rollover of farm property that can prevent the realization of capital gains or recapture of capital cost allowance (i.e. tax depreciation) on farm property when it is transferred to a child or grandchild. The eligibility requirements are not identical for both strategies, although in many situations both are available to decrease or defer tax on transfers of qualifying farm property.

Using the Intergenerational Farm Property Rollover

Canadian farm property, including shares of a family farm corporation, enjoys an additional tax benefit in the nature of a tax deferral. More specifically, a farmer may be able to transfer the interest in the family farm to Canadian resident children on a tax-deferred basis either during his/her lifetime or at death. In general, the child will inherit the parent's tax cost base, so the deferred gain could be taxable when the child subsequently disposes of the property. In theory, farms that are passed down from generation to generation could escape capital gains tax indefinitely. The requirements for farm property for this rule are different from the Capital Gains Deduction requirements and as such this tax deferral may not be available even where the farm property qualifies for the Capital Gains Deduction. Even where the Intergenerational Rollover is available, there may still be a tax liability to your estate if your Executor opts to forego it since your beneficiaries intend to sell the property and receive the proceeds instead of the farm property itself (assuming the Capital Gains Deduction is not available).

Incorporating Tax Planning Strategies for Farm Property into Your Estate Plan

Ideally, the use of the Capital Gains Deduction and Intergenerational Rollover tax planning strategies for farm properties should be orchestrated to achieve the maximum benefit, where available. This can be particularly tricky where some family members will inherit the farm property or carry on the farming business and others will not. Conflicts can arise between the competing interests of these beneficiaries. What benefits one beneficiary from a tax perspective may reduce the value of another beneficiary's inheritance. It is important that your estate plan take into consideration whether these tax strategies will be available and their effect on all beneficiaries and your estate as a whole. For example, the Intergenerational Rollover can save estate taxes, but ultimately the tax on the unrealized gain may be payable by the child who receives or inherits the farm property because the tax cost base will not be increased. Conversely, the tax cost base of other property inherited by the other children will generally be the fair market value at the time of death and additional tax will only be payable on further increases in value after the transfer to them.

Conclusion

Tax and estate planning involving the family farm requires consultation with professional advisors as the rules are extremely technical and complex. In addition, each individual's situation will be unique in many respects requiring the expertise of a professional to customize the appropriate plan or solution which fits your particular circumstances and personal objectives. You may require a tax advisor, estate planning lawyer and a professional appraisal. Your BMO Nesbitt Burns Investment Advisor can help you to identify your needs and refer you to the appropriate professional(s) for further assistance.

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